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Relevant Docket Entries

UNITED STATES COURT OF APPEALS

For the Second Circuit

Superintendent of Insurance of the State of New York, as Liquidator of Manhattan Casualty Company,

Plaintiff-Appellant,

—against—

Bankers Life and Casualty Company, et al.,

Defendants-Appellees.

Date	Proceedings
March 26, 1970	Argument heard (by: Lumbard, Hays, CJJ & Blumenfeld, DJ).
July 22, 1970	Judgment Affirmed, Blumenfeld, DJ.
July 22, 1970	Dissenting in separate opinion, Hays, CJ.
July 22, 1970	Filed Judgment.
September 30, 1970	Filed order denying petition for rehearing.
September 30, 1970	Filed order denying petition for rehearing in banc.
October 7, 1970	Issued Mandate.

Relevant Docket Entries

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

[SAME TITLE]

DATE	PROCEEDINGS
Aug. 19, 1968	Filed Complaint and issued summons.
April 17, 1968	Filed defendant Bankers, Life Motion for Summary Judgment.
June 19, 1968	Memo Endorsed on motion filed 4-17-68. Motion for summary judgment is denied without prejudice, until the question of the jurisdiction of this Court to act over it is determined by appropriate direct hearing on deft's challenge to the jurisdiction of this Court. So ordered — Ryan, J.
July 10, 1968	Filed defts — Belgian — American Banking & Trust Co. — affidavit & Notice of motion for judgment on the pleadings.
July 15, 1968	Filed deft. Bankers Life & Casualty Company notice of motion to dismiss.
September 6, 1968	Defts (Garvin, Bantel & Co.) affidavit & Notice of motion for judgment on the pleadings, etc.
September 10, 1968	Deft's (Irving Trust Co.) Notice of motion to dismiss complaint.
June 3, 1969	Opinion # 35912 — The Court dismisses the complaint as to the movants & hereby directs that judgment be entered for movants. So ordered. Herlands, J.
June 4, 1969	Judgment — Defts, Bankers Life & Casualty Co., Belgian American Banking Corp. & Belgian American Bank & Trust Co., have judgment against the pltff., Superintendent of Insurance of

Relevant Docket Entries

Date	Proceedings
	the State of N.Y., as Liquidator of Manhattan Casualty Co., dismissing the complaint as to them. Herlands, J.
June 9, 1969	Filed Memo Endorsed on defts Garvin, et ano's motion for judgment on the pleadings, etc. filed 9-6-68. Motions to dismiss are granted without prejudice to prosecution of the action pltff filed & is pending in the Supreme Court, County of New York.
June 9, 1969	Filed Memo Endorsed on deft (Irving Trust) motion filed 9-10-68 — motions to dismiss are granted without prejudice to prosecution of the action pltff filed and is pending in the Supreme Court, County of N.Y.
June 16, 1969	Filed Notice of settlement & order that the Clerk enter judgment against the pltff the Superintendent of Insurance of the State of New York, as Liquidator of Manhattan Casualty Co., dismissing the complaint against deft., Irving Trust Co., for lack of jurisdiction & that the dismissal of the complaint is without prejudice to the prosecution of the action that Supt. of Insurance, etc. has commenced in the Supreme Court, County of N.Y., Ryan, J.
June 23, 1969	Filed Notice of Settlement & Order that the clerk enter judgment against pltff. dismissing the complaint against defts Garvin, Bantel & Co., and George K. Garvin for lack of jurisdiction & that motion to dismiss is granted without prejudice to the prosecution of the action pltff has commenced in the Supreme Court, County of N.Y. — Ryan, J. Judgment ent.

Complaint

[SAME TITLE]

Plaintiff, by his attorney, Arnold Bauman, as and for his complaint herein respectfully alleges:

1. This action is based on violations of Section 17A of the Securities Act of 1933 (15 U.S.C.A. § 77q(a)). This Court has jurisdiction under Section 22(a) of the same Act (15 U.S.C.A. §77(v)).

2. Plaintiff Thomas Thacher is Superintendent of Insurance of the State of New York. On May 24, 1963 by order of the Supreme Court of the State of New York, plaintiff, as said Superintendent of Insurance, was appointed Liquidator of Manhattan Casualty Company. As Liquidator, he is vested with title to all property, contracts and rights of action of Manhattan Casualty Company.

3. Defendant, Bankers Life and Casualty Company (hereinafter referred to as "Bankers Life"), is a corporation organized and existing under the laws of the State of Illinois.

4. Defendant, Irving Trust Company (hereinafter referred to as "Irving Trust"), is a corporation organized and existing under the laws of the State of New York, with its principal place of business at 1 Wall Street, City and State of New York.

5. Defendant, Belgian American Banking Corporation (hereinafter referred to as "BA Banking"), is a corporation organized and existing under the laws of the State

of New York, with its principal place of business at 52 Wall Street, City and State of New York.

6. Defendant, Belgian American Bank and Trust Company (hereinafter referred to as "BA Trust"), is a corporation organized and existing under the laws of the State of New York, with its principal place of business at 52 Wall Street, City and State of New York.

7. Defendant, Garvin, Bantel & Company (hereinafter referred to as "Garvin, Bantel"), is a partnership engaged in the transaction of business within the State of New York, with its principal place of business at 120 Broadway, City and State of New York.

8. Defendant, New England Note Corporation (hereinafter referred to as "New England Note"), formerly New England Acceptance Co., Inc., is a corporation organized and existing under the laws of the State of Massachusetts.

9. Defendant, George K. Garvin (hereinafter referred to as "Garvin"), is a resident and citizen of the State of New York and a partner in Garvin, Bantel.

10. Defendant, James F. Begole (hereinafter referred to as "Begole"), is a resident and citizen of the State of New York.

11. Defendant, John F. Sweeny (hereinafter referred to as "Sweeny"), is a resident and citizen of the State of New Jersey.

12. Defndant, Standish T. Bourne (hereinafter referred to as "Bourne"), is a resident and citizen of the State of Massachusetts.

Complaint

Plaintiff Alleges Against All Defendants, Upon Information and Belief:

13. Manhattan Casualty Company (hereinafter referred to as "Manhattan"), was incorporated under the laws of the State of New York on January 13, 1949 and commenced business on June 1, 1949. It was authorized as of May 23, 1963 to transact the following kinds of insurance business as defined in Section 46 of the Insurance Law of the State of New York: accident and health, fire, miscellaneous property, water damage, burglary and theft, glass, elevator, collision, personal injury liability, property damage liability, workmen's compensation and employers' liability, fidelity and surety, motor vehicle and aircraft and marine insurance (excluding ocean marine insurance and insurance against loss or damage by reason of injury to the person). In addition, respondent was authorized by the United States Department of Labor to write compensation insurance provided under the Federal Longshoremen's and Harbor Workers' Compensation Act.

14. As of December 31, 1962, Manhattan was authorized to transact business in the States of Connecticut, Delaware, Florida, Maine, Maryland, Massachusetts, New Hampshire, New York, Rhode Island, Vermont, Virginia, West Virginia and the District of Columbia.

15. During all the times hereinafter referred to, Manhattan had its principal office at No. 116 John Street, City and State of New York.

16. On May 24, 1963 the corporate charter of Manhattan was forfeited, surrendered and annulled and Manhattan

was dissolved by order of the Supreme Court of the State of New York, held in and for the County of New York (Honorable Peter A. Quinn, Justice).

17. In November, 1961 Bankers Life was the owner of all of the outstanding shares of Manhattan. The shares so outstanding consisted of 100,000 shares of prior preferred stock, 10,000 shares of preferred stock and 180,000 shares of common stock.

18. Commencing in or about November, 1962, in connection with and in furtherance of the sale of said shares, the defendants and/or their officers, agents and representatives employed a device, scheme and artifice to defraud Manhattan by use, means and instrumentalities of transportation and communication in interstate commerce and/or the mails.

19. Between November, 1961 and January 19, 1962, Bourne and Begole negotiated for the purchase of said outstanding shares of Manhattan with Sweeny, James W. Bourland (hereinafter referred to as "Bourland"), Vice President of Bankers Life, and others.

20. On January 19, 1962 a contract of sale for the said shares was entered into between Begole, as purchaser, and Bankers Life, as seller, of the shares of Manhattan. It provided that the price to be paid Bankers Life was $5,000,000, by bank or certified check, which was to be delivered at the closing on January 24, 1962. The contract was executed for Bankers Life by Bourland, as Vice President; for Manhattan by Bourland, as Executive Vice President, and by Begole.

21. Between January 19, 1962 and January 24, 1962, Bourne stated to Begole that he would provide Begole with the funds necessary to effect the transaction.

22. During this period, for the purpose of concealing the said scheme to defraud, Bourne asked Garvin if he could arrange with a bank to issue $5,000,000 in certificates of deposit and to obtain a loan on those certificates in that amount.

23. Garvin, in furtherance of said scheme, thereupon arranged with BA Trust to issue a certificate of deposit for $5,000,000 in the name of Manhattan. He also arranged with BA Banking to loan $5,000,000 to New England Note upon the security of the certificate of deposit to be issued in the name of Manhattan.

24. On January 23, 1962 Garvin asked C. Joseph Gunter (hereinafter referred to as "Gunter"), Assistant Secretary of Irving Trust, to appear at his office next morning with a check of Irving Trust for $5,000,000, payable to Bankers Life. Garvin told Gunter that the money for the transaction would be provided by the delivery of securities from Chemical Bank New York Trust Company.

25. On January 24, 1962 Gunter appeared at Garvin's office. Begole, who was present, executed two notes totalling $5,250,000, payable to New England Note, in the presence of Bourne, Sweeny, Gunter and Garvin. One of these notes was in the sum of $5,000,000 and bore interest at 7½ percent; the other was in the amount of $250,000 and bore interest at 5 percent. Begole also executed an assignment of the shares of Manhattan of which he was not yet the owner to New England Note.

26. Later that morning, Begole, Sweeny, Garvin and Gunter appeared at the office of Manhattan. Gunter turned over the Irving Trust check for $5,000,000, payable to Bankers Life, to Leo Lehane, Executive Vice President of that company. In return, Gunter was handed an unsealed envelope, the contents of which he did not examine.

27. Shortly thereafter, on January 24, 1962, $5,155,000 in United States Government securities, the property of Manhattan, were transferred through Garvin, Bantel to Irving Trust. They were sold that day to Second District Securities Company for the account of Manhattan by Garvin, Bantel and delivered by Irving Trust to the purchaser. The proceeds of $4,854,552.67 together with other transfers of cash were credited to an account in the name of Manhattan at Irving Trust. The $5,000,000 payment to Bankers Life by Irving Trust was charged against these funds.

28. Later that day, at the request of Garvin, Bantel, Gunter brought to the offices of BA Trust another check of Irving Trust in the amount of $5,000,000 payable to the order of BA Trust. There, he delivered it to Sweeny who turned it over to BA Trust which thereupon issued a certificate of deposit for $5,000,000, payable in six months, accepting the Irving Trust check in payment. Sweeny, as President of Manhattan, endorsed the certificate of deposit to New England Note. Bourne, as President of New England Note, endorsed the certificate of deposit over to BA Banking as collateral security on a six month loan of $5,000,000 made by BA Banking to New England Note. A check of BA Banking in the sum of $5,000,000 was then turned over to Gunter. At the same time BA Banking made another loan to New England Note in the sum of $250,000,

which was secured by the aforementioned outstanding shares of Manhattan. This sum was deposited by New England Note in BA Trust and was disbursed, in part, as follows: Garvin, Bantel—$25,000; Begole—$50,000; Bourne—$50,000; BA Banking—$100,000.

29. All of the actions referred to in paragraphs 27 and 28 were taken with the purpose of concealing the fact that the assets of Manhattan had been reduced by the value of the United States Government securities above referred to, that Bankers Life had been paid the sum of $5,000,000 out of the assets of Manhattan for the sale of the aforementioned outstanding stock of Manhattan, and that Begole had become the ostensible owner of said stock without any cash investment.

30. Until 5:05 P.M. on January 24, 1962, Manhattan had no account at Irving Trust.

31. Between January 24 and January 29, 1962, a series of entries were made on the books of Irving Trust for the purpose of concealing the above transactions.

32. For the purpose of concealing the above transactions, on January 29, 1962 Garvin, at the request of Irving Trust, obtained backdated letters signed by Bourne.

33. On July 24, 1962 the aforementioned certificate of deposit, the alleged loans made by BA Banking to New England Note, and the alleged loans made by New England Note to Begole, all matured. As part of the scheme to defraud and in furtherance thereof, BA Trust issued a new certificate of deposit in the amount of $5,000,000, payable January 24, 1963. This was endorsed by Sweeny, as Treas-

urer, and Begole, as Chairman, of Manhattan. The Begole and New England Note loans were extended to January 24, 1963. On July 24, 1962 Begole, as Chairman of Manhattan, advised BA Trust that in consideration of BA Banking's loan to New England Note it was providing collateral of the $5,000,000 certificate of deposit issued by BA Trust and all of its outstanding shares.

34. On August 30, 1962 Sweeny, as President of Manhattan, wrote BA Trust letters (1) indicating that he was forwarding a non-negotiable certificate of deposit in the amount of $5,000,000 issued by BA Trust and a non-negotiable certificate of deposit in the sum of $500,000 issued by the First National Bank of Boston, (2) requesting BA Trust to hold the $5,000,000 certificate of deposit and, upon maturity, to place that sum in Manhattan's current account with that institution, and (3) requesting BA Trust to hold the $500,000 certificate of deposit for safekeeping and in trust. Said letters were written for the purpose of concealing the reduction of Manhattan's assets by the sale of the United States Government securities referred to in paragraph 27 hereof and for the further purpose of creating the misleading impression that Manhattan's unencumbered assets totalled $5,500,000 more than they in fact did.

35. In mid-January, 1963 it appeared that—

(a) BA Trust owed $5,000,000 plus interest to Manhattan, evidenced by a certificate of deposit.

(b) Manhattan had on deposit at BA Trust a sum in excess of $500,000.

(c) New England Note owed BA Banking $5,250,000 plus interest, which loan BA Banking refused to renew.

36. About January 20, 1963 Bourne asked Garvin, Bantel to arrange to place $5,500,000 in the account of Manhattan upon which certificates of deposit would issue. On January 21, 1963 Begole requested Irving Trust to issue certificates of deposit aggregating $5,500,000 and directed that they be delivered to Garvin, Bantel. Marine Midland allegedly loaned Garvin, Bantel $5,500,000 which was delivered to Irving Trust. The foregoing was done for the purposes set forth in paragraph 34 hereof and was in furtherance of the aforesaid scheme to defraud.

37. On January 25, 1963 BA Trust credited Manhattan with $5,075,616.44, the proceeds of the BA Trust certificate of deposit payable to Manhattan, as well as $515,361.18, the proceeds of another such certificate issued by the First National Bank of Boston payable to Manhattan. At the direction of Manhattan, BA Trust issued its check to Irving Trust in the sum of $5,500,000 and charged Manhattan's account. Irving Trust issued its check to BA Banking in the sum of $5,250,000. BA Banking applied the Irving Trust check in payment of the alleged New England Note loans. The two checks described in this paragraph were exchanged between BA Banking, BA Trust and Irving Trust at a meeting held that day at the office of BA Banking and/or BA Trust. The foregoing was done for the purposes described in paragraph 34 hereof.

38. On April 18, 1963 BA Banking delivered to Begole and Sweeny the shares of stock of Manhattan registered in the name of Begole.

39. For the purposes set forth in paragraph 34 hereof, on May 15, 1963 Irving Trust certified to the New York State Insurance Department that Manhattan had on de-

posit at Irving Trust the sum of $5,500,000 evidenced by the certificates of deposit described in paragraph 36 hereof and further certified that said certificates were free of all liens, claims, or incumbrances, and were not held as security for any loan.

40. The foregoing transactions constituted violations of Section 17A of the Securities Act of 1933 (15 U.S.C.A. § 77q(a)) and caused Manhattan to suffer damages in an amount in excess of $5,500,000.

WHEREFORE, plaintiff demands judgment against defendants Bankers Life and Casualty Company, Irving Trust Company, Belgian American Banking Corporation, Belgian American Bank & Trust Company, Garvin, Bantel & Company, New England Note Corporation, George K. Garvin, James F. Begole, John F. Sweeny and Standish T. Bourne, jointly and severally, for $5,500,000 with interest from the 24th day of January, 1962, together with the costs and disbursements of this action, and for such other, further or different relief as to the Court may seem just and proper.

Dated: New York, New York,
August 15, 1963.

Answer, Bankers Life and Casualty Company

[SAME TITLE]

Defendant BANKERS LIFE AND CASUALTY COMPANY ("Bankers Life"), an Illinois insurance corporation, by its attorneys Jacobs Persinger & Parker, answering the complaint herein:

First: Denies each and every allegation contained in Paragraph "1" of the complaint, except admits that the complaint in this action purports to be based upon alleged violations of Section 17(a) of the Securities Act of 1933 (15 U.S.C.A. §77q(a)).

Second: Denies any knowledge or information sufficient to form a belief as to the truth of any of the allegations contained in Paragraph "2" of the complaint, except alleges, upon information and belief, that an order was entered in the Supreme Court of the State of New York, County of New York, on the 24th day of May, 1963 in a proceeding entitled "In the Matter of the Application of Thomas Thacher as Superintendent of Insurance of the State of New York, for an order to take possession of the property and liquidate the business of and dissolve the corporate charter of Manhattan Casualty Company", Index No. 40931/1963, to which order reference is made for the terms thereof, and admits that Thomas Thacher was, as of the date of the complaint, Superintendent of Insurance of the State of New York.

Third: Admits the allegations contained in Paragraph "3" of the complaint.

Answer, Bankers Life and Casualty Company

Fourth: Denies any knowledge or information sufficient to form a belief as to the truth of any of the allegations contained in Paragraphs "4", "5", "6", "7", "8", "9", "10", "11" and "12".

Fifth: Denies any knowledge or information sufficient to form a belief as to the truth of any of the allegations contained in Paragraph "13" of the complaint, except admits that Manhattan Casualty Company was incorporated under the laws of the State of New York on January 13, 1949 and commenced business on or about June 1, 1949.

Sixth: Denies any knowledge or information sufficient to form a belief as to the truth of any of the allegations contained in Paragraphs "14" and "15" of the complaint.

Seventh: Denies any knowledge or information sufficient to form a belief as to the truth of any of the allegations contained in Paragraph "16" of the complaint, except alleges, upon information and belief, that an order was entered in the Supreme Court of the State of New York, County of New York, on the 24th day of May, 1963 in a proceeding entitled "In the Matter of the Application of Thomas Thacher as Superintendent of Insurance of the State of New York, for an order to take possession of the property and liquidate the business of and dissolve the corporate charter of Manhattan Casualty Company", Index No. 40931/1963, to which order reference is made for the terms thereof.

Eighth: Denies each and every allegation contained in Paragraph "17" of the complaint, except admits that in November, 1961 Bankers Life was the owner of all of the issued and outstanding capital stock of Manhattan Cas-

ualty Company, and that the said issued and outstanding capital stock consisted of 100,000 shares of Prior Preferred Stock, 30,000 shares of Preferred Stock, and 180,000 shares of Common Stock.

Ninth: In answer to Paragraph "18" of the complaint, denies each and every allegation contained therein insofar as any of said allegations are made, or purport to be made, in respect of Bankers Life and/or any of its officers, agents and representatives, and denies any knowledge or information sufficient to form a belief as to the truth of any of the allegations of said Paragraph "18" insofar as any of the allegations contained therein are made in respect of the other defendants and/or their officers, agents and representatives.

Tenth: Denies each and every allegation contained in Paragraph "19" of the complaint.

Eleventh: Denies each and every allegation contained in Pargagraph "20" of the complaint, except admits that a certain contract was made on January 19, 1962 to which reference is made for the terms thereof, that Bankers Life executed the said contract by James W. Bourland, Vice President, that Manhattan Casualty Company executed the said contract by James W. Bourland, Executive Vice President, and that the said contract was executed by James F. Begole.

Twelfth: Denies any knowledge or information sufficient to form a belief as to any of the allegations contained in Paragraphs "21", "22", "23", "24" and "25".

Thirteenth: Denies each and every allegation contained in Paragraph "26" of the complaint, except admits that in

the forenoon of January 24, 1962 a contract closing took place at the offices of Manhattan Casualty Company, that Bankers Life received a check of Irving Trust Company in the sum of $5,000,000 payable to the order of Bankers Life, and that in consideration therefor Bankers Life delivered the certificates for all of the issued and outstanding capital stock of Manhattan Casualty Company together with assignments thereof.

Fourteenth: Denies any knowledge or information sufficient to form a belief as to the truth of any of the allegations contained in Paragraphs "27", "28", "29", "30", "31", "32", "33", "34", "35", "36", "37", "38" and "39".

Fifteenth: In answer to Paragraph "40" of the complaint, denies the allegation contained therein that the "foregoing transactions" referred to in said Paragraph "40" constituted violations of Section 17(a) of the Securities Act of 1933 (15 U.S.C.A. §77q(a)), and denies any knowledge or information sufficient to form a belief as to the truth of any of the other allegations contained in said Paragraph "40".

For a First Affirmative Defense, Bankers Life Alleges:

Sixteenth: The complaint fails to state a claim upon which relief may be granted against Bankers Life.

For a Second Affirmative Defense Bankers Life Alleges:

Seventeenth: Contrary to the allegations of Paragraph "1" of the complaint, neither this action nor any claim

alleged against Bankers Life is properly based upon any violation of Section 17(a) of the Securities Act of 1933 (15 U.S.C.A. §77q(a)).

Eighteenth: Bankers Life has not been properly or sufficiently served with process in this action, the purported service of the summons and complaint in this action upon Bankers Life having occurred in the State of Illinois.

Nineteenth: By reason of the matter in this defense alleged, this Court lacks jurisdiction over the person of Bankers Life under Section 22(a) of the Securities Act of 1933 (15 U.S.C.A. §77v(a)).

Wherefore, defendant Bankers Life and Casualty Company asks judgment dismissing the complaint against it together with the costs and disbursements of this action.

Answer, Irving Trust Company

[SAME TITLE]

Defendant Irving Trust Company by its attorneys, Winthrop, Stimson, Putnam & Roberts, for its answer to the complaint herein alleges:

1. Answering the allegations of Paragraph 1 of the complaint, this defendant admits that the complaint in this action is based on alleged violations of Section 17(a) of the Securities Act of 1933 (15 U.S.C.A. § 77q(a)). Except as herein expressly admitted, this defendant denies each and every allegation contained in Paragraph 1 of the complaint.

2. Answering the allegations of Paragraph 2 of the complaint, this defendant admits that on May 24, 1963 by Order of the Supreme Court of the State of New York Thomas Thacher, as Superintendent of Insurance, was appointed Liquidator of Manhattan Casualty Company. Except as herein expressly admitted, this defendant denies on information and belief each and every allegation contained in Paragraph 2 of the complaint.

3. This defendant denies knowledge or information sufficient to form a belief as to each and every allegation contained in Paragraph 3 of the complaint.

4. This defendant admits the allegations of Paragraph 4 of the complaint.

5. This defendant denies knowledge or information sufficient to form a belief as to each and every allegation contained in Paragraphs 5 to 15 inclusive of the complaint.

Answer, Irving Trust Company

6. This defendant admits the allegations of Paragraph 16 of the complaint.

7. This defendant denies knowledge or information sufficient to form a belief as to each and every allegation contained in Paragraph 17 of the complaint.

8. Answering the allegations of Paragraph 18 of the complaint, this defendant denies knowledge or information sufficient to form a belief as to each and every allegation contained in said paragraph relating to acts or actions of persons or corporations other than itself or its officers or its agents or its representatives. In all other respects this defendant denies each and every allegation contained in Paragraph 18 of the complaint.

9. This defendant denies knowledge or information sufficient to form a belief as to each and every allegatiion contained in Paragraphs 19 to 23 inclusive of the complaint.

10. Answering the allegations in Paragraph 24 of the complaint, this defendant admits that (a) on January 23, 1962 Mr. George Garvin, of Garvin, Bantel & Co., asked Mr. C. J. Gunter, Assistant Secretary of Irving Trust Company, if Mr. Gunter could have a check of Irving Trust Company for $5,000,000 available for delivery on January 24, 1962; and (b) on January 24, 1962 Mr. Garvin asked Mr. Gunter to bring to the office of Garvin, Bantel & Co. a check of Irving Trust Company for $5,000,000 payable to Bankers Life and Casualty Company and advised Mr. Gunther that the money to cover the check would be provided by the proceeds of sale of securities which would be delivered from Chemical Bank New York Trust Company. Except as herein expressly admitted this defendant denies

each and every allegation contained in Paragraph 24 of the complaint.

11. Answering the allegations of Paragraph 25 of the complaint, this defendant admits that on the morning of January 24, 1962 Mr. Gunter appeared at the office of Garvin, Bantel & Co. and that Messrs. Begole, Bourne, Sweeny and Garvin were present. This defendant denies that on that occasion Mr. Begole executed any notes payable to New England Note Corporation or to anyone else in the presence of Mr. Gunter. Except as herein expressly admitted or denied, this defendant denies knowledge or information sufficient to form a belief as to each and every allegation contained in Paragraph 25 of the complaint.

12. Answering the allegations of Paragraph 26 of the complaint, this defendant admits that (a) on the morning of January 24, 1962 Messrs. Gunter, Begole and Sweeny went to the office of Manhattan Casualty Company from the office of Garvin, Bantel & Co.; (b) at the office of Manhattan Casualty Company Mr. Gunter delivered to Mr. Sweeny an Irving Trust Company check for $5,000,000 payable to Bankers Life and Casualty Company; and (c) during the course of the meeting at Manhattan Casualty Company Mr. Sweeny gave Mr. Gunter an unsealed envelope which was returned to Mr. Sweeny the same day without Mr. Gunter having examined the contents thereof. Except as herein expressly admitted, this defendant denies each and every allegation contained in Paragraph 26 of the complaint.

13. Answering the allegations of Paragraph 27 of the complaint, this defendant admits that (a) on January 24, 1962, shortly after Mr. Gunter's return to Irving Trust

Company from the office of Manhattan Casualty Company, $5,155,000 face value United States Government securities, which it was informed were the property of Manhattan Casualty Company, were delivered to Irving Trust Company by Chemical Bank New York Trust Company; (b) the said securities were sold on that date for the account of Manhattan Casualty Company to Second District Securities Company and were delivered by Irving Trust Company into the account of Second District Securities Company at Irving Trust Company; (c) proceeds of the sale of the said Government securities in the amount of $4,854,552.67, and amounts arising from the deposit of checks, were credited to an account in the name of Manhattan Casualty Company at Irving Trust Company; and (d) on the afternoon of January 24, 1962 the Irving Trust Company check payable to the order of Bankers Life and Casualty Company in the amount of $5,000,000 was charged against the proceeds of the sale of the said Government securities, but this defendant alleges that this entry was mistakenly made and that subsequent entries on its books were made to reflect the facts as Irving Trust Company understood them. Except as herein expressly admitted, this defendant denies knowledge or information sufficient to form a belief as to each and every allegation contained in Paragraph 27 of the complaint.

14. Answering the allegations of Paragraph 28 of the complaint, this defendant admits that (a) on the afternoon of January 24, 1962 Mr. Gunter, at the request of Mr. George Garvin of Garvin, Bantel & Co., brought to the offices of Belgian American Banking Corporation and/or Belgian American Bank & Trust Company an Irving Trust Company check in the amount of $5,000,000 payable to the

order of Belgian American Bank & Trust Company; (b) Mr. Gunter delivered the said check to Mr. Sweeny; and (c) while at the Belgian American offices Mr. Gunter received from Mr. Sandrisser a Belgian American Banking Corporation check for $5,000,000 payable to the order of Irving Trust Company New York for A/C of: New England Acceptance Co., Inc. Except as herein expressly admitted, this defendant denies knowledge or information sufficient to form a belief as to each and every allegation contained in Paragraph 28 of the complaint.

15. Answering the allegations of Paragraph 29 of the complaint, this defendant denies that any actions of Irving Trust Company and/or its officers, agents and representatives were taken for the purpose alleged in Paragraph 29 of the complaint. Except as herein expressly denied, this defendant denies knowledge or information sufficient to form a belief as to each and every allegation contained in Paragraph 29 of the complaint.

16. Answering the allegations of Paragraph 30 of the complaint, this defendant admits that an account of Manhattan Casualty Company was opened at Irving Trust Company on January 24, 1962. Except as herein expressly admitted, this defendant denies each and every allegation contained in Paragraph 30 of the complaint.

17. This defendant denies each and every allegation contained in Paragraph 31 of the complaint.

18. Answering the allegations of Paragraph 32 of the complaint, this defendant admits that, because instructions regarding the transactions alleged in the complaint were received from Mr. Garvin of Garvin, Bantel & Co., Irving

Trust Company requested Mr. Garvin to obtain from New England Acceptance Co., Inc. and from any other necessary persons back dated authorizations for actions taken by Irving Trust Company, pursuant to instructions of Mr. Garvin. This defendant denies that any such request was made for the purpose of concealing any of the transactions alleged in the complaint. Except as herein expressly admitted or denied, this defendant denies knowledge or information sufficient to form a belief as to each and every allegation contained in Paragraph 32 of the complaint.

19. This defendant denies knowledge or information sufficient to form a belief as to each and every allegation contained in Paragraphs 33 to 35 inclusive, of the complaint.

20. Answering the allegations of Paragraph 36 of the complaint, this defendant admits that (a) a letter dated January 21, 1963 signed by Mr. Begole, as Chairman of Manhattan Casualty Company, requested Irving Trust Company to issue bearer Certificates of Deposit in the amount of $5,500,000 and directed delivery of said Certificates to Garvin, Bantel & Co.; and (b) on January 22, 1963 Irving Trust Company was advised that The Marine Midland Trust Company had transferred $5,500,000 in Federal funds to Irving's account at the Federal Reserve Bank, and in return for this transfer of Federal funds Irving Trust Company delivered, upon the instructions of Garvin, Bantel & Co., to The Marine Midland Trust Company, Irving Trust Company bearer Certificates of Deposit in the amount of $5,500,000. This defendant denies that any actions were taken by Irving Trust Company and/or its officers, agents and representatives for the purposes set forth in Paragraph 34 of the complaint or in furtherance of the alleged scheme to defraud. Except as herein ex-

pressly admitted or denied, this defendant denies knowledge or information sufficient to form a belief as to each and every allegation contained in Paragraph 36 of the complaint.

21. Answering the allegations of Parapraph 37 of the complaint, this defendant admits that on January 25, 1963 a representative of Irving Trust Company appeared at a meeting at the offices of Belgian American Banking Corporation and/or Belgian American Bank & Trust Company for the sole purpose of delivering Irving Trust Company's check to Belgian American Banking Corporation in the amount of $5,250,000 and receiving in return therefor a Belgian American Bank & Trust Company check payable to the order of Irving Trust Company in the amount of $5,500,000. This defendant denies that any actions were taken by Irving Trust Company and/or its officers, agents and representatives for the purposes described in Paragraph 34 of the complaint. Except as herein expressly admitted or denied, this defendant denies knowledge or information sufficient to form a belief as to each and every allegation contained in Paragraph 37 of the complaint.

22. This defendant denies knowledge or information sufficient to form a belief as to each and every allegation contained in Paragraph 38 of the complaint.

23. Answering the allegations of Paragraph 39 of the complaint, this defendant admits that on or about May 15, 1963 it delivered a communication to a person who identified himself as a representative of the New York State Insurance Department. For the contents of said communication this defendant asks leave to refer to the original thereof when the same is produced and proven at the trial

of this action. Except as herein expressly admitted, this defendant denies each and every allegation contained in Paragraph 39 of the complaint.

24. This defendant denies each and every allegation contained in Paragraph 40 of the complaint.

For an Affirmative Defense to the Claim Alleged in the Complaint

Defendant Irving Trust Company alleges on information and belief that:

25. By order of the Supreme Court of the State of New York held in and for the County of New York, entered on May 24, 1963, Manhattan Casualty Company was dissolved and plaintiff was appointed Liquidator thereof. Plaintiff commenced this action as such Liquidator.

26. As Liquidator, plaintiff sues as the representative of creditors and stockholders, and plaintiff has the duty to effectuate distribution of any recovery in this action to creditors and stockholders of Manhattan Casualty Company entitled to share therein.

27. Although the Superintendent of Insurance has submitted to the Supreme Court of the State of New York a report indicating that as of March 31, 1963 the excess of liabilities over admitted assets of Manhattan Casualty Company was $1,202,161.86, plaintiff is praying for damages herein in excess of $5,500,000. The recovery prayed for in this action is therefore primarily for the benefit of the dissolved Manhattan Casualty Company's stockholders.

28. If, as plaintiff himself alleges, the sole stockholder of Manhattan Casualty Company participated in the fraud

upon that corporation alleged in the complaint, any present holder of its stock either participated in the alleged fraud or became a stockholder subsequent thereto and cannot share in the distribution of any recovery for damages suffered as a result of such fraud. Plaintiff does not have the right to maintain this action as the representative of any such stockholder, nor to recover damages for distribution to any such stockholder.

WHEREFORE, this defendant demands judgment dismissing the complaint against it and granting such other and further relief as to this Court may seem just and proper, together with the costs and disbursements of this action.

Answer, Belgian-American Banking Corporation and Belgian-American Bank and Trust Company

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[SAME TITLE]

Defendants BELGIAN-AMERICAN BANKING CORPORATION and BELGIAN-AMERICAN BANK AND TRUST COMPANY, by Sullivan & Cromwell, their attorneys, answering the complaint herein:

1. Deny each and every allegation contained in paragraphs 1, 23 and 40.

2. Answering paragraph 2, deny that plaintiff is Superintendent of Insurance, admit that plaintiff was Superintendent of Insurance when this action was commenced, and admit the other allegations of said paragraph.

3. Admit the allegations contained in paragraphs 5, 6 and 38.

4. Deny knowledge or information sufficient to form a belief as to the truth of each and every allegation contained in paragraphs 3, 4, 7, 8, 9, 10, 11, 12, 13, 14, 15, 16, 17, 19, 20, 21, 22, 24, 25, 26, 27, 30, 31, 32, 36 and 39.

5. Answering paragraph 18, deny each and every allegation of said paragraph as to defendant Belgian-American Banking Corporation, defendant Belgian-American Bank and Trust Company and their officers, agents and representatives, and deny knowledge or information sufficient to form a belief as to the truth of each and every other allegation contained in said paragraph.

Answer, Belgian-American Banking Corporation and Belgian-American Bank and Trust Company

6. Answering paragraph 28, admit that in the afternoon of January 24, 1962, C. Joseph Gunter brought to the offices of Belgian-American Bank and Trust Company a check of Irving Trust Company in the amount of $5,000,000 payable to the order of Belgian-American Bank and Trust Company; admit that said check was handed to defendant Sweeny, who delivered it to Belgian-American Bank and Trust Company, against which Belgian-American Bank and Trust Company issued a certificate of deposit in the amount of $5,000,000 maturing in six months; admit that the certificate of deposit was endorsed on behalf of Manhattan Casualty Company by defendant Sweeny and Milton Katz to the order of New England Acceptance Company, Inc.; admit that the certificate of deposit was endorsed on behalf of New England Acceptance Company, Inc. by defendant Bourne to the order of Belgian-American Banking Corporation; admit that the said certificate of deposit was delivered to defendant Belgian-American Banking Corporation as collateral for a six-month loan of $5,000,000 made by Belgian-American Banking Corporation to New England Acceptance Company, Inc.; admit that Belgian-American Banking Corporation loaned $250,000 to New England Acceptance Company, Inc. secured by the pledge of 100,000 shares of prior preferred stock of Manhattan Casualty Company, 30,000 shares of preferred stock of Manhattan Casualty Company and 180,000 shares of common stock of Manhattan Casualty Company; admit that the amount of $250,000 was deposited by New England Acceptance Company, Inc. in an account at Belgian-American Bank and Trust Company, that upon instructions from New England Acceptance Company, Inc. $100,000 were transferred from this account to Belgian-American Banking Corporation as

prepaid interest on the loan to New England Acceptance Company, Inc. in the amount of $5,000,000, that a check drawn on this account to the order of defendant Garvin, Bantel & Co. in the amount of $25,000 was paid, and that a check drawn on this account to the order of defendant James F. Begole in the amount of $50,000 was paid; and, except as so admitted, deny knowledge or information sufficient to form a belief as to the truth of each and every allegation of said paragraph.

7. Answering paragraph 29, deny each and every allegation of said paragraph as to defendants Belgian-American Banking Corporation and Belgian-American Bank and Trust Company and deny knowledge or information sufficient to form a belief as to the truth of each and every other allegation of said paragraph.

8. Answering paragraph 33, admit that on July 24, 1962, the certificate of deposit in the amount of $5,000,000 dated January 24, 1962 and the loan in the amount of $5,000,000 by Belgian-American Banking Corporation to New England Acceptance Company, Inc. matured, and, except as so admitted, deny each and every allegation contained in said paragraph.

9. Answering paragraph 34, admit that defendant Sweeny, as President of Manhattan Casualty Company, wrote letters dated August 30, 1962, to Belgian-American Bank and Trust Company, to which defendants refer for their language, and, except as so admitted, deny knowledge or information sufficient to form a belief as to the truth of each and every allegation contained in said paragraph.

Answer, Belgian-American Banking Corporation and Belgian-American Bank and Trust Company

10. Answering paragraph 35, admit that loans made by Belgian-American Banking Corporation to New England Note Corporation in the total amount of $5,250,000 plus interest were payable on January 24, 1963, admit that Belgian-American Banking Corporation refused to renew said loans, and, except as so admitted, deny each and every allegation of said paragraph.

11. Answering paragraph 37, admit that Irving Trust Company issued its check to Belgian-American Banking Corporation in the amount of $5,250,000 and that said check was accepted by Belgian-American Banking Corporation as payment of loans to New England Note Corporation; admit that on January 25, 1963, Belgian-American Bank and Trust Company credited the account of Manhattan Casualty Company in the amount of $5,075,616.44, and in the amount of $515,361.08, the latter amount having been received against delivery of a certificate of deposit issued by the First National Bank of Boston and payable to Manhattan Casualty Company and admit that at the direction of Manhattan Casualty Company, Belgian-American Bank and Trust Company issued its check drawn to the order of Irving Trust Company in the amount of $5,500,000, which was debited to the account of Manhattan Casualty Company; and, except as so admitted, deny each and every allegation contained in said paragraph.

WHEREFORE, defendants Belgian-American Banking Corporation and Belgian-American Bank and Trust Company demand that the complaint herein be dismissed with costs.

Dated: October 8, 1963.

Amended Answer, Garvin, Bantel & Co.

[SAME TITLE]

Defendant, GARVIN, BANTEL & CO., by DUGAN & ROSEN, their attorneys, answering the complaint herein by amended answer.

1. Denies each and every allegation contained in paragraphs "1, 22, 23, and 40" of the complaint.

2. Denies any knowledge or information sufficient to form a belief as to each and every allegation contained in Paragraphs 3, 4, 5, 6, 8, 10, 11, 12, 13, 14, 15, 16, 17, 19, 20, 21, 24, 25, 26, 30, 31, 32, 33, 34, 35, 37, 38, and 39.

3. Answering the allegations of Par. 2 of the Complaint, upon information and belief, denies that plaintiff is the Superintendent of Insurance, and admits all other allegations.

4. Admits the allegations contained in paragraph 7.

5. Answering the allegations of par. 9, denies any knowledge or information sufficient to form a belief, except admits that at all times mentioned, GEORGE K. GARVIN was a partner in GARVIN, BANTEL & CO.

6. Answering Par. 18, denies each and every allegation as to defendant, Garvin, Bantel & Co. and denies any knowledge or information sufficient to form a belief as to the allegations pertaining to all other defendants.

7. Denies each and every allegation contained in Par. 27 except admits that on or about January 24, 1962, MAN-

HATTAN CASUALTY COMPANY requested the sale of United States Government securities in the face amount of $5,155,000, at Market, and to transfer the proceeds to the account of Manhattan Casualty Company at IRVING TRUST COMPANY. That pursuant to such request, the United States Government securities were sold to Second District Securities Company for the account of Manhattan Casualty Company for the sum of $4,854,552.67 and the proceeds thereof were duly transferred to Irving Trust Company for the account of Manhattan Casualty Company.

8. Denies each and every allegation of Par. 28 and 29 as it pertains to defendant, Garvin, Bantel & Co, and denies any knowledge or information sufficient to form a belief insofar as it pertains to all other defendants, except admits receiving a fee of $25,000 from NEW ENGLAND NOTE CORPORATION for arranging its loan with BELGIAN AMERICAN BANK & TRUST CO.

9. Upon information and belief denies each and every allegation contained in Paragraph 36, except admits that defendant Garvin, Bantel & Co. borrowed $5,500,000 from MARINE MIDLAND which was secured by bearer Certificates of Deposit in a like amount, issued by Irving Trust Company.

As and For an Affirmative Defense

Upon information and belief, the defendant, Garvin, Bantel & Co. alleges:

10. By order of the Supreme Court of the State of New York held in and for the County of New York, entered on May 24, 1963, Manhattan Casualty Company was dis-

solved and planitiff was appointed Liquidator thereof. Plaintiff commenced this action as such Liquidator.

11. As Liquidator, plaintiff sues as the representative of creditors and stockholders, and plaintiff has the duty to effectuate distribution of any recovery in this action to creditors and stockholders of Manhattan Casualty Company entitled to share therein.

12. Although the Superintendent of Insurance has submitted to the Supreme Court of the State of New York a report indicating that as of March 31, 1963 the excess of liabilities over admitted assets of Manhattan Casualty Company was $1,202,161.86, plaintiff is praying for damages herein in excess of $5,500,000.00. The recovery prayed for in this action is therefore primarily for the benefit of the dissolved Manhattan Casualty Company's stockholders.

13. That the plaintiff herein does therefore bring this action on behalf of the Stockholders of Manhattan Casualty Company.

14. That plaintiff alleges in his verified complaint, that the stockholder participated in the alleged fraud.

15. That any subsequent stockholder took the Stock with full knowledge of such alleged fraud and that the plaintiff herein, bringing this action on behalf of said Stockholders is therefore himself impinged with the same alleged fraud.

16. That the plaintiff therefore does not have the right to maintain this action.

WHEREFORE, this defendant demands judgment dismissing the complaint against it and granting such other and further relief as to this Court may seem just and proper, together with costs and disbursements of this action.

Answer, George K. Garvin

[SAME TITLE]

Defendant, GEORGE K. GARVIN, by his attorneys, Javits & Javits, answering the complaint herein, respectfully alleges:

1. Denies each and every allegation contained in paragraphs "1", "22", "23", "24", "25", "26", "32" and "40" of the complaint.

2. Admits the allegations contained in paragraph "2" of the complaint, except denies that plaintiff is the Superintendent of Insurance of the State of New York.

3. Denies any knowledge or information sufficient to form a belief as to each and every allegation contained in paragraphs "3", "4", "5", "6", "8", "10", "11", "12", "13", "14", "15", "17", "19", "20", "21", "30", "31", "33", "34", "35", "37", "38" and "39" of the complaint.

4. Admits the allegations contained in paragraph "7" of the complaint.

5. Admits the allegations contained in paragraph "9" of the complaint, except denies that defendant, George K. Garvin, is a partner in Garvin, Bantel & Company since as of November 1, 1963.

6. Denies any knowledge or information sufficient to form a belief as to the allegations contained in paragraph "16" of the complaint, except admits that an order was entered in the Supreme Court of the State of New York,

County of New York, on the 24th day of May, 1963 in a proceeding entitled "In the Matter of the Application of THOMAS THACHER as Superintendent of Insurance of the State of New York, for an order to take possession of the property and liquidate the business of and dissolve the corporate charter of Manhattan Casualty Company", Index No. 40931/1963, to which order reference is made for the terms thereof.

7. Denies each and every allegation contained in paragraph "18" of the complaint with respect to defendant, George K. Garvin, and denies knowledge or information sufficient to form a belief as to the allegations contained therein with respect to the other defendants.

8. Denies any knowledge or information sufficient to form a belief as to each and every allegation contained in paragraph "27" of the complaint, except admits that on or about January 24, 1962, Manhattan Casualty Company requested the sale of United States Government securities in the face amount of $5,155,000, at Market, and to transfer the proceeds to the account of Manhattan Casualty Company at Irving Trust Company. That pursuant to such request, the United States Government securities were sold to Second District Securities Company for the account of Manhattan Casualty Company for the sum of $4,854,552.67 and the proceeds thereof were duly transferred to Irving Trust Company for the account of Manhattan Casualty Company.

9. Denies each and every allegation contained in paragraph "28" of the complaint with respect to defendant, George K. Garvin, and denies knowledge or information sufficient to form a belief as to the allegations contained

therein with respect to the other defendants, except admits that defendant, Garvin, Bantel & Company, received a fee from New England Note Corporation in the amount of $25,000.

10. Denies each and every allegation contained in paragraph "29" of the complaint with respect to defendant, George K. Garvin, and denies knowledge or information sufficient to form a belief as to the allegations contained therein with respect to the other defendants.

11. Denies each and every allegation contained in paragraph "36" of the complaint, except admits that defendant, Garvin, Bantel & Company, borrowed the sum of $5,500,000 from Marine Midland which amount was secured by bearer certificates of deposit issued by defendant, Irving Trust Company, in the amount of $5,500,000.

AS AND FOR AN AFFIRMATIVE DEFENSE:

Upon information and belief, the defendant, GEORGE K. GARVIN, alleges:

12. By order of the Supreme Court of the State of New York held in and for the County of New York, entered on May 24, 1963, Manhattan Casualty Company was dissolved and plainitff was appointed Liquidator thereof. Plaintiff commenced this action as such Liquidator.

13. As Liquidator, plaintiff sues as the representative of creditors and stockholders, and plaintiff has the duty to effectuate distribution of any recovery in this action to creditors and stockholders of Manhattan Casualty Company entitled to share therein.

Answer, George K. Garvin

14. Although the Superintendent of Insurance has submitted to the Supreme Court of the State of New York a report indicating that as of March 31, 1963 the excess of liabilities over admitted assets of Manhattan Casualty Company was $1,202,161.86, plaintiff is praying for damages herein in excess of $5,500,000. The recovery prayed for in this action is therefore primarily for the benefit of the dissolved Manhattan Casualty Company's stockholders.

15. If, as plaintiff alleges, the sole stockholder of Manhattan Casualty Company participated in the fraud upon that corporation alleged in the complaint, any present holder of its stock either participated in the alleged fraud or became a stockholder subsequent thereto and cannot share in the distribution of any recovery for damages suffered as a result of such fraud. Plaintiff does not have the right to maintain this action as the representative of any such stockholder, nor to recover damages for distribution to any such stockholder.

WHEREFORE, defendant GEORGE K. GARVIN demands judgment dismissing the complaint against him and granting such other and further relief as to this Court may seem just and proper, together with the costs and disbursements of this action.

Opinion, Ryan, J. Dated June 19, 1968, Denying Motion For Summary Judgment

[SAME TITLE]

Defendant, BANKERS LIFE AND CASUALTY COMPANY, moves on the pleadings and on the record of proceedings in this case for summary judgment. Rule 56(b) and (c). It urges that, upon the extensive record of more than 12,000 pages of deposition testimony and 500 exhibits amassed in the four years that this suit has been pending, no issues as to the liability of movant have emerged. In support of its motion, it has submitted affidavits of its counsel as the person having actual knowledge of the record in the case.

At the same time, counsel for BANKERS LIFE obliquely challenges the jurisdictional basis for the suit, saying "in view of the lack of any factual basis for including Bankers Life as a defendant in this action, it is respectfully submitted there is no need to detain the Court with consideration of the inapplicability of Section 17(a) of the Securities Act of 1933 as a jurisdictional basis for the present action. It is noteworthy, however, that in 1965 plaintiff's attorney, in evident recognition of the fact that the instant action was improperly brought, commenced another action in the Supreme Court of the State of New York in and for the County of New York seeking identical relief against the same defendants."

Counsel for plaintiff, ignoring this statement, has submitted an affidavit to the effect that a question of fact as to BANKERS LIFE'S knowledge of the fraud charged to have been perpetrated in the sale of MANHATTAN'S assets has been raised by the circumstances surrounding the sale and

Opinion, Ryan, J. Dated June 19, 1968, Denying Motion For Summary Judgment

that, in any event, there is an issue of credibility of witnesses precluding the granting of judgment.

Because of the question raised by counsel for BANKERS LIFE and because of the Court's own doubts as to the jurisdiction of this Court over the matters alleged in the complaint, we do not decide whether plaintiff has carried the burden of sustaining its claim against movant by pointing to a specific genuine issue of fact. We deny the motion for summary judgment not on the merits and without prejudice for the reason that this Court is powerless to pass upon it while its jurisdiction is thus challenged.

The complaint filed in August, 1963, says that "it is based on violations of Section 17A of the Securities Exchange Act of 1933 (15 U.S.C.A. 77q(a))". The plaintiff is the Superintendent of Insurance of the State of New York as Liquidator of MANHATTAN CASUALTY COMPANY, an insurance company incorporated under New York law. Although defendant BANKERS LIFE is a foreign corporation whose principal place of business is not disclosed, most of the defendants are New York residents, jurisdiction would, therefore, lie only on the basis of the statute pleaded, and not on diversity.

The complaint alleges that BANKERS LIFE in 1961 was the owner of all the outstanding shares of MANHATTAN; that commencing in or about November 1962, in connection with and in furtherance of the sale of said shares, the defendants employed a device, scheme and artifice to defraud MANHATTAN by instrumentalities in interstate commerce; that defendants BOURNE and BROOKS negotiated with Sweeny, who is not identified, and Bourland, the vice president of BANKERS LIFE, and others for the purchase of these shares; that a contract of sale was entered into between

Opinion, Ryan, J. Dated June 19, 1968,
Denying Motion For Summary Judgment

Bucola as purchaser and Bankers Life as seller of the shares of Manhattan, in exchange for a bank or certified check in the sum of five million dollars; that the contract was executed by Bourland for Bankers Life, and for Manhattan by Bourland as Executive Vice President, and by Bucola. There follows a series of allegations concerning the raising by Bucola of the agreed-on purchase price by a sale of Manhattan's securities, in which several of the defendants other than Bankers Life are named. It is then alleged in the complaint that at the office of Manhattan a check payable to Bankers Life was turned over to its Executive Vice President in return for which an unsealed envelope was handed over to Irving Trust, the maker of the check. The complaint then continues to allege that the check paid to Bankers Life was charged against securities, the property of Manhattan, which had been credited to the account of Manhattan at Irving Trust, and that the defendants other than Bankers Life engaged in a series of transactions in order to conceal the fact that the assets of Manhattan had been reduced by the value of the securities referred to; that Bankers Life had been paid out of the assets of Manhattan for the sale by it of its outstanding stock of Manhattan; and that Bucola had become the ostensible owner of said stock without any cash investment. Nowhere is it charged that the negotiations for the raising of the purchase price were participated in by Bankers Life or even that it had any knowledge of them. Finally, it is alleged that for the purpose of concealing the above facts defendant Irving Trust certified to plaintiff that Manhattan had on deposit $5,500,000 of unencumbered assets and that all this constituted violations of Section 17A, for which a money judgment in the amount of the securities—$5,500,000—is sought.

Opinion, Ryan, J. Dated June 19, 1968, Denying Motion For Summary Judgment

As Judge Friendly wrote in *Bartle, Trustee*, etc. v. *Markson*, 357 Fed. 2d 517: ". . . the question of federal jurisdiction should be faced in limine before reaching the issue of the trustee's capacity to sue, see Arrowsmith v. United Press International, 320 F.2d 219, 221 (2 Cir. 1963). . . . a federal court which has noted a possible lack of federal jurisdiction must generally decline to produce further until it has favorably resolved the doubt, Mitchell v. Maurer, 293 U.S. 237, 55 S.Ct. 162, 79 L.Ed. 338 (1934), . . .".

It is difficult to determine from a reading of this complaint precisely what is charged against defendant BANKERS LIFE other than the conclusory allegation as to its participation in a scheme to defraud MANHATTAN, presumably to the detriment of creditors, although that, too, is not pleaded . . . See *Bartle* v. *Markson*, *supra*.

Section 17A, which is the only law with which this court is concerned, prohibits "in the offer or sale of any securities" in interstate commerce (1) to employ a device, scheme or artifice to defraud; or (2) to obtain money or property by means of an untrue statement of a material fact or an omission of a material fact; or (3) to engage in any transaction which would operate as a fraud upon the purchaser.

On this statutory language the Courts have engrafted certain requisites which must be met before a claim under this Section will be sustained. Travelling on the language is not sufficient to charge fraud. Neither does the statute represent a cure for all corporate frauds. *Barnett* v. *Anaconda*, 238 F. Supp. 766, 770.

Counsel for the respective parties should be given an opportunity to affirmatively show wherein the complaint does or does not sufficiently plead facts to support a violation of the statute as well as plaintiff's standing to sue as a person aggrieved under the statute. See *Mooney* v. *Vitolo*, Civ. 67-

Opinion, Ryan, J. Dated June 19, 1968, Denying Motion For Summary Judgment

1500 S.D.N.Y., Dec. 6, 1967. On the facts alleged, jurisdiction does not emerge with the clarity it should for federal purposes.

Motion for summary judgment is denied without prejudice, until the question of the jurisdiction of this Court to act over it is determined by appropriate direct hearing on the defendant's challenge to the jurisdiction of this Court.

So ordered.

Dated: June 19, 1968.

/s/ Sylvester J. Ryan
U.S.D.J.

Notice of Motion to Dismiss Complaint, Bankers Life and Casualty Company

[SAME TITLE]

SIRS:

PLEASE TAKE NOTICE that, upon the Order of Hon. Sylvester J. Ryan, U.S.D.J., duly made, entered and filed in the office of the Clerk of this Court on the 19th day of June, 1968, upon all of the pleadings and upon the plaintiff's attorney's statement to the Court on November 6, 1963 set forth in the memorandum of law submitted herewith, the undersigned will move this Court at the United States Courthouse, Foley Square, New York, New York on the 23rd day of July, 1968, at 10:00 o'clock in the forenoon of that day or as soon thereafter as counsel may be heard,

(a) for an order, pursuant to an Order of this Court, dated June 19, 1968, per Ryan, J., and pursuant to Rules 12(c) and 12(h) of the Federal Rules of Civil Procedure, granting judgment on the pleadings dismissing the complaint as to defendant Bankers Life and Casualty Company, together with costs and disbursements of this action, on the ground that said defendant is entitled to judgment as a matter of law by reason of the following:

(i) the action is purportedly based on Section 17(a) of the Securities Act of 1933, 15 U.S.C.A., §77q(a), whereas the complaint fails to state facts constituting any violation of said Section 17(a);

(ii) plaintiff is not a person aggrieved under Section 17(a) since plaintiff is not a defrauded purchaser

of securities and Section 17(a), at most, provides a remedy in favor only of defrauded purchasers of securities; and

(iii) the Court lacks jurisdiction over the subject matter of this action; and

(b) for such other, further and different relief as to the Court may seem just and proper.

Dated: New York, New York
July 12, 1968

Yours, etc.,

JACOBS PERSINGER & PARKER

Notice of Motion to Dismiss Complaint, Irving Trust Company

[SAME TITLE]

SIRS:

PLEASE TAKE NOTICE that upon the pleadings in this action, upon the order of Hon. Sylvester J. Ryan, U.S.D.J., entered June 19, 1968, and upon all the proceedings heretofore had herein, the undersigned will move this Court, at a Motion Term to be held in Room 506, United States Court House, Foley Square, New York, New York, on the 24th day of September, 1968, at 10:00 o'clock in the forenoon, or as soon thereafter as counsel can be heard, for an order pursuant to Rules 12(c) and 12(h) of the Federal Rules of Civil Procedure dismissing the complaint herein as against defendant Irving Trust Company, directing the entry of final judgment, and granting such other and further relief as the Court may deem just and proper. The grounds of this motion are that (1) the Court does not have jurisdiction over the subject matter of this action and (2) the complaint fails to state any claim upon which relief can be granted.

Dated: New York, New York
September 9, 1968

Yours, etc.,

WINTHROP, STIMSON, PUTNAM & ROBERTS

Notice of Motion to Dismiss Complaint, Belgian-American Banking Corporation and Belgian-American Bank and Trust Company

[BANK TITLE]

SIRS:

PLEASE TAKE NOTICE that upon the pleadings in this action and the opinion of Honorable Sylvester J. Ryan, District Judge, filed June 19, 1968, the undersigned will move this Court, at the Motion Part thereof, Room 506, United States Courthouse, Foley Square, New York, N.Y., on the 23rd day of July, 1968, at 10:00 A.M. or as soon thereafter as counsel can be heard, for an order pursuant to Rules 12(c) and 12(h)(3), Federal Rules of Civil Procedure, granting judgment on the pleadings dismissing the complaint on the grounds that plaintiff fails to state a claim upon which relief can be granted and that this Court lacks jurisdiction over the subject matter of this action.

Dated: New York, N.Y.
July 3, 1968

Yours, etc.,

SULLIVAN & CROMWELL

Notice of Motion to Dismiss Complaint, Garvin Bantel and Company and George K. Garvin

[SAME TITLE]

Sirs:

PLEASE TAKE NOTICE that upon the pleadings and the opinion of Honorable Sylvester J. Ryan, District Judge, filed on June 19, 1968, the undersigned will jointly move this Court at the Motion Part thereof, Room 506, United States Courthouse, Foley Square, in the Borough of Manhattan, City and State of New York, on the 24th day of September, 1968 at ten o'clock in the forenoon of that day, or as soon thereafter as counsel can be heard for an order pursuant to Rules 12(c) and 12(h)(3) of the Federal Rules of Civil Procedure, granting judgment on the pleadings dismissing the complaint on the ground that plaintiff fails to state a claim upon which relief can be granted and that this Court lacks jurisdiction over the subject matter of this action.

Dated: New York, N. Y.
September 5, 1968

Yours, etc.

BASCH AND SEITS
POLETTI, FREIDIN, PRASHKER,
FELDMAN & GARTNER

Opinion, Herlands, J. Dismissing the Complaint

[SAME TITLE]

HERLANDS, *District Judge:*

The issue for decision is another illustration of the recurring problem whether plaintiff's claim belongs in the state courts or whether plaintiff has stated a cause of action under the federal securities laws—the Securities Act of 1933 (1933 Act), 15 U.S.C. §§77 *et seq.* (1964) and the Securities Exchange Act of 1934 (1934 Act), 15 U.S.C. §§78 *et seq.* (1964), and the pertinent rules and regulations of the Securities and Exchange Commission. This question is posed by motions made by three of the defendants to dismiss the complaint.

The movants are defendants Bankers Life and Casualty Company ("Bankers Life"), Belgian American Banking Corporation ("Belgian American Banking"), and Belgian American Bank and Trust Company ("Belgian American Trust").

The grounds of the motions are (1) that there is lack of jurisdiction over the subject matter; (2) that the complaint fails to state a claim upon which relief can be granted; and (3) that plaintiff lacks the requisite standing to recover damages for alleged violations of the 1933 and 1934 Acts.

Defendants maintain that plaintiff may not recover because (i) it[1] is neither a defrauded purchaser nor a de-

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[1] The Superintendent of Insurance of the State of New York is the nominal plaintiff. Since he, as Liquidator, has been vested with all rights of the Manhattan Casualty Company (hereinafter "Manhattan"), the rights he seeks to assert are precisely those possessed by Manhattan at the time of his appointment as Liquidator. Consequently, the questions of standing to initiate suit and of injury will be determined as if Manhattan itself had brought suit.

frauded seller of securities within the meaning of the 1933 and 1934 Acts, and (ii) these federal statutes have never been and should not be interpreted so as to make them applicable to remedy the injury allegedly resulting from the facts asserted in the complaint. A comprehensive restatement of the facts alleged in the complaint is requisite for a comprehension of the following discussion of the critical legal issues.[2]

EVENTS PRIOR TO JANUARY 24, 1962

Manhattan Casualty Company ("Manhattan") was a New York corporation engaged in the insurance business. At the beginning of the period under consideration, Bankers Life was the owner of all of the outstanding shares of Manhattan stock. The management of Manhattan apparently was distinct from that of Bankers Life.

During the fall of 1961, Bankers Life decided to discontinue its ownership of Manhattan. Sometime in November,

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[2] These motions were made pursuant to an order entered by District Judge Sylvester J. Ryan on June 19, 1968 denying, without prejudice, a motion for summary judgment under Fed. R. Civ. P. 56(b), (c) because subject matter jurisdiction was doubtful. In light of that motion and its disposition, this Court will not treat the instant motions as motions for summary judgment by looking outside the face of the pleadings. The Court will rule on the questions of jurisdiction and the sufficiency of the complaint solely on the basis of its allegations.

The complaint, however, does not contain "a short and plain statement" (Fed. R. Civ. P. 8(a)) of the claim; its averments are not "simple, concise and direct" (Fed. R. Civ. P. 8(e)); and the intricacies of the pleaded transactions cannot immediately be interrelated.

As a consequence, the Court has been compelled to undertake the task of describing the sequence of events as coherently as the complaint permits. The Court has noted, when necessary, the gaps in the narrative which were filled through other sources (these facts not playing a part in the disposition of the motions) and those gaps which remain void.

1961,[3] Bankers Life, through James W. Bourland, a vice-president of Bankers Life, commenced negotiations for the sale of all the Manhattan stock. The prospective purchasers were two individuals, defendants Standish T. Bourne and James F. Begole. (¶19).

At about the time that Bankers Life decided to sell its Manhattan stock, it ousted the defendant John F. Sweeny from the presidency of Manhattan.[4] Sweeny, however, established contact between Begole and Bourne and Bankers Life. Probably at that time, Sweeny also arranged with Begole and Bourne that he should be reinstated as president of Manhattan when, and if, Begole and Bourne acquired control of Manhattan.

The negotiations drew to a successful conclusion. On January 19, 1962, a contract for the purchase and sale of all the Manhattan shares was entered into by Bankers Life (still through Bourland, as its vice-president) and Begole, individually. Begole, alone and in his own name, was to purchase the Manhattan shares. He agreed to deliver to Bankers Life at the closing on January 24, 1962 a bank check or certified check in the amount of $5,000,000. (¶20).

The complaint does not charge that any misrepresentations, deceit or non-disclosures had been made or practiced upon any party in connection with this contract of purhase and sale. The complaint is devoid of allegations respecting

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[3] Paragraph 18 of the complaint alleges that the acts in furtherance of and connection with the scheme to defraud were commenced in November, 1962. However, it is obvious from the succeeding paragraphs that this date is a typographical error, and that the correct date is November, 1961.

[4] This information was conveyed to the Court at oral argument (Transcript, September 10, 1968 at 23-25). Sweeny's former relationship with Manhattan, his discharge by Bankers Life, and his subsequent connection with Bourne and Begole, are important for an understanding of the alleged fraud.

the net worth of Manhattan or its general financial position; thus, there is nothing upon which to base any finding as to the equity or unfairness of the contract.

Financing

Sometime after January 19, 1962 but before the closing date (January 24, 1962), Bourne had stated to Begole that he, Bourne, would arrange for the financing of the stock acquisition. (¶21). Bourne made contact with defendant George K. Garvin (a partner in the note brokerage firm Garvin, Bantel & Company, also a party defendant) and asked Garvin to have a bank issue certificates of deposit in the face amount of $5,000,000 and then to have a bank make a loan, using the certificates as collateral. (¶22). Other than the conclusory statement that the purpose of these two transactions was to conceal the scheme to defraud, there is nothing in the complaint's factual allegations that would explain the significance of these two transactions which, taken together, appear to be self-cancelling.

Acting upon Bourne's request, Garvin, prior to January 24, 1962, arranged with Belgian American Trust to issue a certificate of deposit in the face amount of $5,000,000, in the name of Manhattan. (¶23). The complaint is silent, however, as to whether Belgian American Trust was informed of the method of payment for this certificate of deposit. Presumably, it was so informed. Garvin also arranged with Belgian American Banking to loan to defendant New England Note Corporation—a company controlled by Bourne—$5,000,000 upon the collateral of the certificate of deposit that would be issued in the name of Manhattan. (¶23).

Also in preparation for the closing of January 24, 1962, Garvin met with C. Joseph Gunther, an officer of defendant

Irving Trust Company. Gunther agreed to bring to Garvin's office on January 24, 1962 a check in the amount of $5,000,000 payable to Bankers Life. This check was to be paid for by the delivery of various securities from Chemical Bank New York Trust Company to Irving Trust Company. (¶24).

TRANSACTIONS OF JANUARY 24, 1962

The Closing, the Payment for the Manhattan Shares, and the Sale of Manhattan's Portfolio

On the morning of January 24, 1962, Bourne, Sweeny, Begole, and Gunther appeared at Garvin's office. Begole then executed two notes,[5] both payable to New England Note Corporation. One was in the amount of $5,000,000, interest payable at 7½ per cent; the other in the amount of $250,000, interest payable at 5 per cent. The complaint is silent as to whether these notes were delivered. Begole also executed in favor of New England Note Corporation an assignment of the Manhattan stock that he would receive. (¶25). The economic purpose underlying these transactions is neither explained nor readily discernible.

Sweeny, Begole, Garvin, and Gunther then went to Manhattan's office for the closing of the sale of Manhattan stock. Gunther handed the $5,000,000 Irving Trust Company check to Leo Lehane, an executive vice-president of Bankers Life, and received in return an unsealed envelope. (¶26). The complaint contains no other allegations pertaining to the actual closing. It would be sheer speculation to assume that

[5] There are no allegations respecting the obligor, *i.e.*, whether these were personal notes of Begole or were to become obligations of Manhattan. It seems more likely that they were personal obligations of Begole because of the assignment of the shares by Begole to New England Note Corporation, which may have been intended as an assignment for security purposes.

the envelope did or did not contain the shares of Manhattan stock.

Nevertheless, Begole and Bourne presumably did obtain possession of the shares of Manhattan stock at some point because (as will be detailed later) these shares apparently were physically tendered as security for a loan.

Once the ownership of the shares of Manhattan stock apparently changed hands on January 24, 1962, the following took place: United States Government securities owned by Manhattan, in the face amount of $5,155,000, were delivered through Garvin, Bantel & Company to Irving Trust Company.

During the same day of January 24, 1962, Garvin, Bantel & Company sold these securities for Manhattan's account. Irving Trust Company delivered these securities to the purchaser and received the proceeds of $4,854,552.67, which amount it then credited to an account in Manhattan's name.

Manhattan (by some person not named) then transferred some cash to Irving Trust Company, which amount was also credited to this Manhattan account.

Finally, the $5,000,000 check of Irving Trust Company that Gunther had handed to Leo Lehane of Bankers Life was charged against this same Manhattan account in Irving Trust Company (¶27)—which had been built up by the crediting of the proceeds of the sale of Manhattan's portfolio of United States Government securities plus the additional Manhattan cash.

The net effect of the foregoing series of financial manoeuvres appears to be, up to this point, as follows:

(i) Bankers Life received $5,000,000 in cash for which it had ostensibly delivered all of its Manhattan stock;

(ii) Presumably, Begole (or possibly Bourne—through New England Note Corporation—as a result of Begole's

prior assignment of the Manhattan stock Begole would receive) owned all of the stock of Manhattan;

(iii) Manhattan's portfolio of United States Government securities had been sold off;

(iv) Manhattan transferred some cash to Irving Trust, thereby further building up its account;

(v) Irving Trust applied the total credit—created out of the Manhattan portfolio proceeds and the Manhattan cash—to the payment of the $5,000,000 Irving Trust check which Gunther had given Lehane of Bankers Life;

(vi) As a result, Manhattan's net assets were diminished by approximately $5,000,000; and

(vii) Payment of $5,000,000 to Bankers Life for the purchase of its Manhattan stock was effected by using Manhattan's own assets to pay for all of its stock, which Begole or Bourne thereby obtained without using a dollar of their own money.

Though the complaint is devoid of factual allegations on the point, apparently Sweeny assumed the office of president of Manhattan immediately after the acquisition of the Manhattan shares.[6] Conceivably it was he who directed the Chemical Bank to deliver Manhattan's portfolio of United States Government securities to Irving Trust, authorized the sale of these securities, and then transferred

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[6] In light of allegations that Bourne was required by Irving Trust, through Garvin, to execute certain backdated letters (¶32) and that Irving Trust made various entries after January 24, 1962 for the purpose of concealing the transactions of January 24, 1962 (¶31), the absence of any similar allegations respecting Sweeny's grant of authority might indicate that Begole, in fact, did immediately name a board of directors, which met and appointed Sweeny as president, granting him sufficient authority to effect the various transactions on Manhattan's behalf.

Manhattan cash to Irving Trust in order to cover completely the $5,000,000 Irving Trust check payable to Bankers Life.

The complaint is explicit, however, in charging that Sweeny, in his capacity as president of Manhattan, effected other transactions on January 24, 1962.

The Certificates of Deposit

Later that day, Gunther, at the request of Garvin, Bantel & Company, brought another Irving Trust check in the amount of $5,000,000, payable to Belgian American Trust, to the offices of Belgian American Trust. Gunther gave the check to Sweeny who delivered it to someone at Belgian American Trust. Belgian American Trust then issued a six-months certificate of deposit in the amount of $5,000,000 in the name of Manhattan, pursuant to Garvin's prior discussions with Belgian American Trust. Sweeny received the certificate of deposit and, in his capacity as president of Manhattan, immediately endorsed it to New England Note Corporation. (¶28).

Bourne, as president of New England Note Corporation, accepted the certificate of deposit from Sweeny; and, in turn, Bourne endorsed the certificate to Belgian American Banking.[7]

Belgian American Banking then made a six-months loan of $5,000,000 to New England Note Corporation and took possession of the certificate of deposit as collateral.

Belgian American Banking drew a $5,000,000 check, apparently payable to Irving Trust Company and delivered it to Gunther. (¶28).

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[7] The exact relationship between Belgian American Banking and Belgian American Trust was never explained in the complaint, nor at oral argument nor in counsel's briefs. It does not appear that, for purposes of these motions, this information is crucial.

To recapitulate for a moment at this point:

(1) Irving Trust Company in effect exchanged its $5,000,000 check payable to Belgian American Trust for a $5,000,000 check drawn by Belgian American Banking, payable to Irving Trust Company.

(2) Belgian American Trust issued a $5,000,000 certificate of deposit which in reality was paid for by the $5,000,000 emanating from Belgian American Banking in the form of the loan in the same amount made by Belgian American Banking to New England Note Corporation and collateralized by the very same $5,000,000 certificate of deposit of Belgian American Trust.

(3) The certificate of deposit issued by Belgian American Trust was issued in the name of Manhattan, though Manhattan did not pay for it and was in fact only an intermediate conduit for this certificate of deposit as it made its way from Belgian American Trust to Belgian American Banking.

At the same time that Belgian American Banking made the $5,000,000 loan to New England Note Corporation, it made another loan of $250,000 to New England Note Corporation and received as security the Manhattan shares assigned by Begole to New England Note Corporation. (¶28). Once again the complaint is not precise and does not allege specifically whether the Manhattan shares were actually delivered to Belgian American Banking.

The proceeds of this $250,000 loan were deposited in Belgian American Trust and the following amounts totalling $225,000 were disbursed: Garvin, Bantel—$25,000; Begole—$50,000; Bourne—$50,000; Belgian American Banking—$100,000. (¶28). It would be supposititious to attempt any explanation for the payment of the above $225,000. The

complaint does not allege that this transaction constituted fraud, but only that the various transactions with the Belgian American banks were effected for the purpose of concealing the fact that Manhattan's assets had been reduced by the sale of its securities—a fact which does, indeed, emerge clearly from the above labyrinthine transactions.

EVENTS SUBSEQUENT TO JANUARY 24, 1962

The complaint alleges other events which occurred subsequent to January 24, 1962, such as the making of entries by Irving Trust Company for the purpose of concealing the transactions of January 24, 1962 (¶31); and, for similar purposes, the execution by Bourne of various backdated letters which were given to Garvin on January 29, 1962 (¶32).

On July 24, 1962, the six-months certificate of deposit matured; the loan by Belgian American Banking to New England Note Corporation and the loans by New England Note Corporation to Begole fell due. Belgian American Trust then issued a new six-months certificate of deposit in Manhattan's name in the amount of $5,000,000. This certificate was endorsed by Begole (as chairman of Manhattan) and Sweeny (as treasurer) and posted as collateral for the Belgian American Banking-New England Note Corporation loans which were then extended to January 24, 1963. (¶33). The Manhattan stock at this point appears to be physically in the possession of Belgian American Banking as collateral for the loans. Finally, Begole's loans ($5,000,000 and $250,000) from New England Note Corporation were also extended to January 24, 1963. (¶33). It is alleged that these transactions were entered into for the purpose of furthering the scheme to defraud. (¶33).

While it would appear from the foregoing that Belgian American Banking was in possession of the $5,000,000 certificate of deposit, on August 30, 1962 Sweeny (in his capacity as president of Manhattan) wrote Belgian American Trust that he was forwarding to Belgian American Trust a non-negotiable certificate of deposit in the amount of $5,000,000 which was to be paid at maturity into Manhattan's current account at Belgian American Trust. Sweeny also stated that he was forwarding a non-negotiable certificate of deposit in the amount of $500,000 issued by the First National Bank of Boston, which certificate was to be held by Belgian American Trust in safekeeping. There are no allegations respecting the purchaser of this certificate, the source of funds for its issuance, nor any fraudulent activity in connection with it. Again, the complaint alleges that the purpose of this legerdemain was to conceal the actual reduction in Manhattan's assets and to create the misleading impression that Manhattan had $5,500,000 more in unencumbered ssets than it, in fact, did have. (¶34).

Repayment of Belgian American Banking Loans

Sometime in January, 1963, Belgian American Banking made known that it would not renew or extend its loans to New England Note Corporation, which notes fell due on January 24, 1963. (¶35). Accordingly, beginning on or about January 20, 1963, Bourne and Begole initiated another series of camouflaging transactions.

Firstly, Bourne asked Garvin, Bantel to arrange to replace the certificates of deposit which undoubtedly had been carried as assets upon Manhattan's books and the proceeds of which would be required to repay the Belgian American Banking loans. Garvin, Bantel borrowed $5,500,000 from Marine Midland Bank and Trust Co. and delivered the funds to Irving Trust Company. Irving Trust Company,

on January 21, 1963, issued, at Begole's request, certificates of deposit in the amount of $5,500,000, apparently with Manhattan as payee.[8] These certificates were delivered to Garvin, Bantel. (¶36).

Secondly, on January 25, 1963, Belgian American Trust credited Manhattan's account with the proceeds and interest of the two certificates of deposit referred to in Sweeny's letter of August 20, 1962—$5,075,616.44 representing the amount credited with respect to the Belgian American Trust certificate of $5,000,000 and $515,361.18 representing the proceeds of the First National Bank of Boston certificate of $500,000. (¶37).

At Manhattan's request, Belgian American Trust issued a check in the sum of $5,500,000 to Irving Trust Company and charged Manhattan's account.

Irving Trust Company thereupon drew its own check in favor of Belgian American Banking in the amount of $5,250,000 and charged this amount of $5,250,000 against the credit established by the $5,500,000 check which it had received from Belgian American Trust. The Irving Trust Company check in the amount of $5,250,000 was then applied by Belgian American Banking to the New England Note Corporation loans (of $5,000,000 and $250,000) then due and owing to Belgian American Banking. (¶37).

It is alleged that the exchange of checks between Belgian American Trust and Irving Trust Company and between

[8] Paragraph 36 is silent as to the payee of the Irving Trust certificates. However, since paragraph 39 alleges that Irving Trust certified to the State Insurance Department that it was indebted to Manhattan in the amount of $5,500,000 as evidenced by certificates of deposit, and since the alleged scheme of concealing the diminution of assets would not be effective unless the certificates were in Manhattan's name, it is a reasonable assumption that they were so issued.

Irving Trust Company and Belgian American Banking took place at the same time at a meeting held on January 25, 1963 at the office of one (or possibly both) of the Belgian American banks. (¶37).

As a result of these transactions, it now appeared that Manhattan was the payee of a $5,500,000 certificate of deposit (issued by Irving Trust Company) which, however, had been delivered physically to Garvin, Bantel and then undoubtedly used by Garvin, Bantel as security for its loan of $5,500,000 from Marine Midland Bank.[9]

Manhattan also had approximately $90,000 on deposit in Belgian American Trust representing interest earned by the certificate of deposit and a balance of $250,000 in Irving Trust Company representing the difference between the $5,500,000 check received by Irving Trust Company from Belgian American Trust and the $5,250,000 check issued by Irving Trust Company to Belgian American Banking. There are no allegations respecting interest on the Belgian American Banking-New England Note Corporation loans; and it is likely that Manhattan paid this interest by using the cash balances on deposit in Belgian American Trust and Irving Trust.

Other than these possibilities arising from the interest earned by the certificates of deposit and the interest payable on the loans, the Belgian American banks, as of January 25, 1963, do not figure in any financial transaction.

On April 18, 1963, Belgian American Banking returned to Begole and Sweeny the shares of Manhattan stock which

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[9] There are no allegations, however, regarding the pledge or assignment of this certificate as security nor any allegations regarding an assignment or endorsement by Manhattan of the Irving Trust Company certificate of deposit (of $5,500,000) which presumably would be necessary in order to make this certificate acceptable to Marine Midland Bank as security for Garvin, Bantel's loan.

it had received as collateral on the New England Note Corporation loan. (¶38).

Finally, on May 15, 1963, allegedly for the purpose of concealing the diminution of Manhattan's assets, Irving Trust Company certified to the New York State Insurance Department that Manhattan had on deposit at Irving Trust Company $5,500,000, as evidenced by the certificates of deposit (payable to Manhattan) issued by Irving Trust on January 21, 1963. The certification included statements that the certificates of deposit were free of all liens, claims, or incumbrances and were not held as security for any loan. (¶39). These certificates of deposit, as previously noted, had in fact been delivered to Garvin, Bantel.

The net effect of the myriad financial manoeuvres was that an individual (Begole) or a group of individuals (Begole, Bourne, et al.) obtained control of Manhattan by (1) having Irving Trust Company deliver its $5,000,000 check to Bankers Life (the then sole stockholder of Manhattan); (2) receiving all of Bankers Life's shares of Manhattan, and (3) repaying Irving Trust Company by selling Manhattan's portfolio of United States Government securities and forwarding the proceeds plus some additional cash to Irving Trust Company.

In essence, Manhattan's corporate funds that should have been kept available to meet Manhattan's creditors' and policyholders' claims were thus unlawfully used by Begole for the noncorporate, private purpose of enabling Begole (and those in concert with him) to acquire all of Manhattan's shares.

Since Manhattan, a solvent corporation, was thereby rendered insolvent, the corporation itself was victimized. But, inasmuch as Begole was Manhattan's sole stockholder, the

economic injury was to be borne only by Manhattan's creditors and policyholders.

It is impossible to ascertain with any degree of certainty from the face of the complaint who benefitted from the transaction. Bourne, Sweeny, Begole, Garvin or all of them in concert, may have masterminded and gained from the scheme. As previously noted, Bourne, Begole, Garvin, Bantel and Belgian American Banking received various amounts of cash, totalling $225,000, originating out of the $250,000 loan by Belgian American Banking to New England Note Corporation.

Indeed, if Manhattan had a net worth on January 24, 1962 substantially below $5,000,000, Bankers Life may have been the ultimate beneficiary. Resolution of this puzzlement is not required to decide the present motions.

PLAINTIFF'S LEGAL THEORY AND MOVANTS' CHALLENGES

Plaintiff claims that these transactions, when integrated, constitute violations of section 17(a) of the 1933 Act, 15 U.S.C. §77q(a) because all of the defendants, by their respective participation, employed a device, scheme and artifice to defraud Manhattan. The precise applicability of section 17(a) is never articulated in the complaint. Nevertheless, plaintiff's apparent position is that the bootstrap acquisition of control by Begole, Sweeny and Bourne whereby Manhattan's assets rather than outside funds were the source of the purchase price of Manhattan's shares was fraudulent insofar as Manhattan was concerned. Moreover, in order to retain control of Manhattan without disclosing the means of financing the acquisition of the Manhattan shares, defendants, as part of the same scheme, finagled records and executed intricate financial transactions to conceal and suppress the truth.

Bankers Life and the two Belgian American banks have moved to test the legal sufficiency of this theory as applied to the facts alleged in the complaint. More particularly, these defendants seek an order, pursuant to Fed. R. Civ. P. 12(c), (h), granting judgment on the pleadings and dismissing the complaint as to them on the grounds that the Court lacks federal question or diversity jurisdiction; that plaintiff lacks standing to recover damages for violations of section 17(a) of the 1933 Act; and that the complaint fails to state a claim upon which relief can be granted.

In the context of complaints alleging violations of the securities acts, there is no significant distinction between dismissal for lack of jurisdiction and dismissal for failure to state a cause of action. Federal jurisdiction depends on the existence of a federal question, *i.e.*, the violation of a provision of one of the securities acts. Should the Court determine that the facts alleged do not make out a violation of federal law, and consequently fails to state a claim, the Court, in effect, has also determined that there is no federal question, and thus no jurisdiction. *See Britt* v. *Cyril Bath Co.*, 290 F.Supp. 934 (N.D.Ohio 1968). Therefore, the Court will not attempt, as a matter of formal analysis, to deal separately with these two grounds. Because the same issues of law are raised by both grounds, they will be discussed simultaneously.

The Court initially, however, directs its attention to the question of standing which can be decided without reference to the merits of the claim since this attack on the complaint assumes *arguendo* that it does allege an actual violation of the securities acts and that the Court has jurisdiction.

WHO MAY RECOVER FOR ALLEGED VIOLATIONS OF THE ANTI-FRAUD PROVISIONS OF THE SECURITIES ACTS?

Defendants, in their memoranda, claim that plaintiff may not recover for violations of section 17(a) of the 1933 Act because that section gives rise to a cause of action in a defrauded purchaser only, and that it is obvious from the face of the complaint that Manhattan was not a purchaser of its own stock. At oral argument and in its briefs, plaintiff presents a number of arguments in refutation.

Plaintiff's position is that, for purposes of these motions, it is not limited to section 17(a) of the 1933 Act (the only section explicitly alleged to have been violated) but that it is entitled to have the motions denied if it has standing and if it makes out a claim under *any* federal statute. Plaintiff then asserts that section 10(b) of the 1934 Act, 15 U.S.C. §78j(b) (1964) and S.E.C. Rule 10b-5 are also material; that the complaint does state a cause of action under that section; and that plaintiff has standing to sue for damages resulting from violations of section 10(b) of the 1934 Act and section 17(a) of the 1933 Act.

The Court is not restricted to the particular legal theory of recovery or jurisdictional basis alleged in the complaint. If the facts are alleged with reasonable clarity so as to give adequate notice of the transaction, and if plaintiff is entitled to recover under any legal theory, the complaint is sufficient. 1A Barron & Holtzoff, Federal Practice and Procedure §276.1 (Wright ed. 1960); 2A J. Moore, Federal Practice ¶8.14 (2d ed. 1968).

Moreover, because the operative language of section 10(b) and Rule 10b-5 is so similar to that of section 17(a) of the 1933 Act, the Court will consider the applicability of these provisions. *See Hoover* v. *Allen*, 241 F.Supp. 213, 226 n.7 (S.D.N.Y. 1965).

Only a defrauded purchaser may recover under section 17(a) of the 1933 Act. The statute provides:

> "It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly—
>
> (1) to employ any device, scheme or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

This statute was aimed at fraudulent practices by which sellers of securities could defraud or deceive purchasers. The very purpose of the promulgation of Rule 10b-5 under the 1934 Act was to prohibit individuals or companies from buying securities if they engage in fraud in their purchase. The objective of Rule 10b-5 was to make the same prohibitions contained in section 17(a) of the 1933 Act applicable to purchasers as well as to sellers. *See, e.g., Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461, 463 (2d Cir.), *cert. denied,* 343 U.S. 956, (1952); III L. Loss, securities Regulation at 1423-30 (2d ed. 1961); A. Bromberg, Securities Law: Fraud at 19-20 (1968).

The requirement of being a defrauded purchaser to recover for a violation of section 17(a) has even more recently been upheld. *See, e.g., Schoenbaum* v. *Firstbrook,* 268 F.Supp. 385, 396 (S.D.N.Y. 1967), *aff'd,* 405 F.2d 200

(2d Cir.), *rev'd on other grounds en banc*, 405 F.2d 215 (2d Cir. 1968); *Colonial Realty Corp.* v. *The Curtis Publishing Co.*, CCH Fed. Sec. L. Rep. ¶92, 105 (S.D.N.Y. 1967); *cf. Hoover* v. *Allen*, 241 F.Supp. 213, 223 (S.D.N.Y. 1965).

Rule 10b-5, however, is more expansive than section 17(a) of the 1933 Act. It prohibits fraud or deception by either a purchaser or seller; and its operative language is "in connection with the purchase or sale of any security" as distinguished from the phrase "in the offer or sale of any securities" which appears in Section 17(a) of the 1933 Act.[10] Nevertheless, the standing requirement appears to

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[10] The texts of section 10(b) and Rule 10b-5 are hereafter set forth:

"Section 10. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * * * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest for the protection of investors."

"Rule 10b-5. Employment of Manipulative and Deceptive Devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security."

differ only in that defrauded sellers as well as purchasers are included in the permissible class of potential plaintiffs.

In *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952), plaintiff sought to prosecute a derivative suit against the former president and major shareholder of the corporation, who allegedly had violated section 10(b) and Rule 10b-5 in rejecting, as president, an allegedly favorable merger offer and who then sold his stock to another company at a substantial premium. In affirming the district court's dismissal of the complaint, the court, *inter alia*, held that the action could not be maintained in the corporate name in the absence of an allegation that the plaintiff corporation was either a defrauded purchaser or seller of securities. This holding has been consistently applied. *See, e.g., Chasin* v. *Mencher* 255 F.Supp. 545, 548 (S.D.N.Y. 1965) and cases there cited.

Plaintiff contends that *Birnbaum* is no longer controlling doctrine. It argues that recent case law (mostly developed by the Second Circuit) has eroded the validity of *Birnbaum* and the limitation of standing to defrauded purchasers or sellers.

The Court rejects plaintiff's reading of recent decisions. Though there have been, literally, dozens of cases raising the issue since *Birnbaum*, not one has permitted a plaintiff who has been held to be other than a "purchaser or seller" (as those terms have been interpreted) to maintain an action for damages under Rule 10b-5.

In *Hooper* v. *Mountain States Securities Corp.*, 282 F.2d 195 (5th Cir. 1960), a case much relied on by plaintiff, the court did permit the trustee in bankruptcy to sue in behalf of a corporation whose stock had been issued, without registration, and then publicly distributed by some of the defendants. Plaintiff alleged a violation of Rule 10b-5 in

that the corporation's transfer agent was induced to issue these shares on the basis of fraudulent representations made to the agent by former officers of the bankrupt. The court held that the corporation could maintain its action for the reason that the issuance of stock was a "sale" and since it did not receive full consideration for the valuable shares issued, the corporation was thus a defrauded "seller." *Hooper*, thus, manifestly does not indicate the demise of the purchaser-seller requirement.

Hooper did serve as the genesis for a long string of cases that have permitted corporations to sue for damages when they were the victim of a securities fraud. Yet, in every case, the corporation either qualified as a "seller" since it had issued new shares, or as a purchaser when it redeemed shares or purchased treasury stock.

Other cases are also relied upon by plaintiff to support its thesis that the authority of *Birnbaum* has become attenuated. *Ruckle* v. *Roto American Corporation*, 339 F.2d 24 (2d Cir. 1964), upheld the right of a defrauded *issuer* to recover damages because preventing the perpetration of fraud upon an issuer with the consequent distribution of newly issued and watered stock was one of the chief reasons for the enactment of the securities laws. 339 F.2d at 28. Since an "issuer" is a seller (per *Hooper*), this result is not inconsistent with the *Birnbaum* purchaser-seller requirement. And, although *Ruckle* distinguished *Birnbaum* and *Howard* v. *Furst*[11] on the grounds that the corporations in those cases had not sustained injury, it is clear from the rationale for the *Ruckle* decision that the mere existence of corporate injury was not the crucial, decisive factor; the

[11] 238 F.2d 790 (2d Cir. 1956), *cert. denied*, 353 U.S. 937 (1957) (shareholders may not sue derivatively for injury growing out of S.E.C. proxy rule violations).

emphasis was on the spread of overvalued securities resulting from the fraud on the corporation.

Nor do the other cases cited by plaintiff support its *Birnbaum* erosion thesis. In *Vine* v. *Beneficial Finance Co.*, 374 F.2d 627 (2d Cir. 1967), the court held that a minority shareholder who, pursuant to a short form statutory merger, was forced either to sell his shares to the surviving corporation or to retain shares in a defunct corporation was a "seller", though he retained his shares. The court specifically disclaimed any intention to depart from the traditional purchaser-seller requirement and decided that, under the particular circumstances, plaintiff was, as a practical matter, a seller.

In *A.T. Brod & Co.* v. *Perlow*, 375 F.2d 393 (2d Cir. 1967), the court reversed the dismissal of a complaint which charged that defendant had employed a scheme in refusing to pay for securities he had ordered from plaintiff-broker. The court noted, explicitly, that plaintiff in that case was a purchaser and thus there was no need to delve into the question of whether a broader standing requirement should be adopted. 375 F.2d at 397 n. 3.

It is true that *Brod* implicitly criticized *Birnbaum* in the statement: "Nor do we think it sound to dismiss a complaint merely because the alleged scheme does not involve the type of fraud that is 'usually associated with the sale or purchase of securities'. We believe that §10(b) and Rule 10b-5 prohibit *all* fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception." 375 F.2d at 397. The language the Court of Appeals believed too limited is that of *Birnbaum*.

An analysis of the decision in *Birnbaum*, however, discloses that there were at least two distinct reasons for

dismissing the complaint[12]—the failure of the allegations to state a cause of action, and the lack of standing in the corporation to recover for violations of the securities laws when the corporation was neither a defrauded purchaser nor defrauded seller. The language quoted by *Brod* was the *Birnbaum* court's rationale for dismissal for failure to state a claim; so too, the only issue involved in *Brod* was the question of whether the facts alleged constituted a violation of Rule 10b-5. And thus, while *Brod* must be read as modifying *Birnbaum* on this issue, *Birnbaum's* standing requirements have not been altered.[13]

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[12] One commentator has also noted the tendency to confuse the distinct grounds for decision in *Birnbaum* which results from "an uncritical reading of the general language . . ." *See* A. Bromberg, *supra* at 88.1.

[13] Though not cited by plaintiff to this Court, two other cases have been relied on as authority for the *Birnbaum* "erosion" or "demise" theory. *See* Lowenfels, *The Demise of the Birnbaum Doctrine: A New Era For Rule 10b-5*, 54 Va. L. Rev. 268 (1968). In *Symington Wayne Corp.* v. *Dresser Industries, Inc.*, 383 F.2d 840 (2d Cir. 1967), the court denied, on the grounds of failure to prove irreparable harm, an application for an order enjoining a tender offer allegedly steeped in material misrepresentations and omissions. Though the court reached the merits in a suit brought by the corporation being acquired and two of its shareholders, it specifically refrained from deciding the question of standing. 383 F.2d at 842. In *Mutual Shares* v. *Genesco*, 384 F.2d 540 (2d Cir. 1967), the court did decide that one need not be a purchaser or seller in a suit for an injunction, but held, however, that the trial court's dismissal of the damages claim was correct. *See* 384 F.2d at 547. The injunction was against a continuing deceitful manipulation of the market price of publicly-owned stock; and this conduct was held to create a claim under section 10(b) and Rule 10b-5. The Court explicitly stated that the claim for equitable relief required proof of fewer elements than would a claim for damages.

Lowenfels, *supra*, does not distinguish between the two separate grounds for decision in *Birnbaum;* and thus fails to note that *Brod* modifies *Birnbaum* only with respect to the ground based on failure to state a claim.

Indeed, in *Greenstein* v. *Paul,* 400 F.2d 580 (2d Cir. 1968), the Court of Appeals appeared to foreclose any argument respecting the demise of the *Birnbaum* purchaser-seller requirement:

> "It has long been the rule in this circuit that to maintain an action under §10(b) of the [1934] Act and Rule 10b-5 of the Securities and Exchange Commission the plaintiff must have been a seller of the stock involved. Birnbaum v. Newport Steel Corp., 193 F.2d 461 (C.A. 2, 1952), cert. denied 343 U.S. 956 (1952). Although criticized, Entel v. Allen, 270 F.Supp. 60, 70 (S.D.N.Y., 1967), it is still the rule at least insofar as actions for damages are concerned. Mutual Shares Corp. v. Genesco, Inc., supra."

EXPANSION OF THE PURCHASER-SELLER REQUIREMENT?

Plaintiff argues that, even if the purchaser-seller requirement has not yet been expressly overruled or broadened, the various cases which were cited by plaintiff for that proposition, and discussed by the Court above, at least indicate discontent with the narrow *Birnbaum* rule, forcing the Court of Appeals to choose other means to circumvent its rigors (*e.g.*, interpreting term "seller" broadly). Plain-

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Weitzen v. *Kearns,* 271 F.Supp. 616, 622 (S.D.N.Y. 1967), and *Entel* v. *Allen,* 270 F.Supp. 60, 69 (S.D.N.Y. 1967)—both decided by the same judge—apparently also came to the conclusion that *Birnbaum* was "seriously challenged, if not overruled" by reading *Brod* as questioning *Birnbaum's* holding with respect to standing as well as the scope of Rule 10b-5. However, in *Greenstein* v. *Paul,* 400 F.2d 580 (2d Cir. 1968), the Second Circuit squarely reaffirmed the continuing validity of *Birnbaum* as authority for the rule that to maintain an action for damages under section 10(b) and Rule 10b-5 the plaintiff must have been a seller of the stock involved. *See also Christophides* v. *Porco,* 289 F.Supp. 408 (S.D. N.Y. 1968); *Bound Brook Water Co.* v. *Jaffe,* 284 F.Supp. 702 (D.N.J. 1968).

tiff thus appears to ask this Court to broaden, in an explicit fashion, the standing requirements. Plaintiff refers the Court to the brief of the Securities and Exchange Commission as *amicus curiae* in *Vine* v. *Beneficial Finance Co., supra,* where the S.E.C. argued for such an expansion. Plaintiff argues that this step would eliminate unnecessary complexities, distinctions, and incentives to clever scheming and would achieve greater justice in the individual case. Memorandum of Plaintiff In Opposition to Motions Pursuant to Rules 12(c) and 12(h) Federal Rules of Civil Procedure at 31.

Other reasons have been advanced by commentators for the abandonment of the purchaser-seller prerequisite. *See, e.g.,* Lowenfels, *supra* note 12; Note, *The Purchaser-Seller Rule: An Archaic Tool for Determining Standing Under Rule 10b-5,* 56 Geo. L.J. 1177 (1968).

The rule that this Court is asked to adopt is that anyone who is injured by a violation of the securities acts may sue to recover damages. The Court declines this invitation to expand the traditional standing requirement.

The Court of Appeals has declined to accede to the repeated requests of plaintiffs and *amici curiae* to enlarge the class of potential plaintiffs in actions for damages arising out of violations of Rule 10b-5. In the light of *Greenstein* v. *Paul, supra,* the Court does not discern any imminent doctrinal change by the Court of Appeals. In these circumstances, a district judge may not disregard an established principle of law. Accorlingly, the Court rules that only a defrauded purchaser or seller may sue for damages arising from a violation of section 10(b) of the 1934 Act and S.E.C. Rule 10b-5.

IS PLAINTIFF A DEFRAUDED PURCHASER OR SELLER OF SECURITIES?

The complaint charges a violation of the anti-fraud provisions of the 1933 Act in the purchase and sale of the shares of Manhattan stock on January 24, 1962. (¶¶1, 18, 40). The seller of these shares was Bankers Life and the purchaser was Begole. (¶20). From the face of the pleadings, it thus appears that plaintiff—Manhattan—was neither a purchaser nor a seller of the security (shares of Manhattan stock) which was the subject of the alleged fraud.

At oral argument, however, plaintiff's counsel suggested that—in view of the fact that Begole did not furnish any "fresh" consideration for the purchase of the shares and that, ultimately, it was Manhattan's funds which paid for the shares—Manhattan should be considered the purchaser. (Tr. at 30). While it is true that a corporation can be a purchaser of its own stock within the meaning of the securities laws, *see, e.g., O'Neill* v. *Maytag,* 230 F.Supp. 235 (S.D.N.Y.), *aff'd,* 339 F.2d 764 (2d Cir. 1964), a corporation cannot be the purchaser of *all* of its own stock unless the shares were cancelled and a general dissolution occurred. This is so because a corporation cannot maintain its status as a separate or existing entity (or fictional person) without having another entity or individual serve in the capacity of proprietor or owner.

This Court deems, as a matter of law, the fact that plaintiff may have been the ultimate source of funds for the purchase of Manhattan shares (*i.e.*, the proceeds of the sale of Manhattan's portfolio of United States Government securities were received by Irving Trust Company and credited to Manhattan's account, which thereafter was charged with the $5,000,000 check delivered by Irving Trust Company to Bankers Life) insufficient to establish plaintiff as the purchaser of Manhattan shares because it was never

intended that plaintiff would take title to those shares. This Court holds that, insofar as section 17(a) of the 1933 Act and section 10(b) of the 1934 Act are concerned, a purchaser of securities is one who was a party to a transaction whereby he was to assume ownership of securities in exchange for valuable consideration. Under this definition, plaintiff fails to achieve the status of purchaser and, consequently, may not assert a cause of action for a violation of the securities laws with respect to the purchase and sale of the Manhattan shares.

Though the complaint alleges fraud only in the purchase and sale of the Manhattan shares, plaintiff now adopts the new position that, as a purchaser of a certificate of deposit, and as a seller of United States Government securities, plaintiff has standing to sue in this action (Tr. at 32-35).

Without commenting on the propriety of ruling on the sufficiency of a complaint based on amendatory allegations presented in open court and not formally set forth in the complaint, the Court concludes that if, within the meaning of the securities acts, fraudulent schemes were employed in connection with the sale of Manhattan's portfolio of United States Government securities, plaintiff, *if damaged*, may maintain a suit to recover. Manhattan was a seller of those securities, though management perhaps breached its duties to the corporation in authorizing or ratifying the sale; and, if the corporation was damaged through fraudulent activities, plaintiff may recover damages.

With respect to plaintiff's standing deriving from its alleged "purchase" of various certificates of deposit,[14] the

[14] The Court's discussion of purchases of certificates of deposit does not refer to the $500,000 First National Bank of Boston certificate of deposit, regarding which the complaint is generally devoid of information. From the facts alleged, it does not appear that any fraudulent act was practiced relative to this certificate, and thus the question of standing is irrelevant.

Court is convinced that plaintiff was not a purchaser, despite the fact that it tendered to Belgian American Trust, Irving Trust Company's check for $5,000,000 and received a $5,000,000 certificate of deposit payable to itself. Since, by prearrangement, this certificate was endorsed to New England Note Corporation which delivered it to Belgian American Banking as collateral for the $5,000,000 loan from Belgian American Banking to New England Note Corporation, and the proceeds of this loan were given directly to Irving Trust Company in payment for the $5,000,000 check that had paid for the certificate of deposit, this entire transaction was a "wash" and had no economic reality. As such, Manhattan was not a "purchaser" of a "security" but was merely participating as a conduit for the sole purpose of having its name appear as payee which enabled the fraud to become further camouflaged.

The Court is mindful of the argument that Manhattan's portfolio of United States Government securities was the ultimate source of funds for financing all the transactions in the three certificates of deposit and that the misappropriation of the proceeds of the sale of Manhattan's portfolio constituted the fraud. What is of controlling importance is that the facts as pleaded do not portray Manhattan as the purchaser of the two Belgian American Trust certificates of deposit. Neither Manhattan's portfolio nor the proceeds thereof was the immediate consideration for the issuance of these two certificates.

Nor was Manhattan a purchaser of the third certificate of deposit,—the Irving Trust Company $5,500,000 certificate of deposit which was paid for by the proceeds of the Marine Midland $5,500,000 loan to Garvin, Bantel. Garvin, Bantel and Irving Trust Company were the only parties to the transaction whereby this certificate was issued, al-

though Manhattan was the payee of the certificate. Garvin, Bantel, as previously noted, received physical delivery of the certificate and presumably used this certificate of deposit as collateral for the $5,500,000 loan which initially furnished the consideration for the issuance of the certificate.

Therefore, the Court need not reach the novel and difficult question of whether certificates of deposit of this nature fall within the statutory definition of the term "security".[14a]

[14a] Section 2(1) of the 1933 Act, 15 U.S.C. §77b(1) (1964), defines the term "security" for the purpose of that act to include "any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certicate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a 'security', or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing."

Section 3(a)(10) of the 1934 Act, 15 U.S.C. §78c(a)(10) (1964), sets forth the meaning of the term "security" for the purpose of that act:

> "The term 'security' means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a 'security'; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of any days of grace, or any renewal thereof the maturity of which is likewise limited."

The certificates of deposit in this case were not issued for a security—they were issued for cash and are pieces of paper "evidencing the existence of a time deposit." *S.E.C.* v. *Fifth Avenue Coach Lines, Inc.*, 289 F.Supp. 3, 31 (S.D.N.Y. 1968). Thus, they would not be deemed "securities" as a species of the class of instruments designated in the statute as "certificate of deposit for a security."

The S.E.C., however, has taken the position that the anti-fraud provisions of the securities acts apply to deposit and share accounts in national banks. *See* 31 Fed. Reg. 16, 581, *reprinted in* CCH Fed. Sec. L. Rep. ¶77,421 (1966-67 Transfer Binder).

The Supreme Court, in *Tcherepnin* v. *Knight*, 389 U.S. 332 (1967), held that withdrawable capital shares in a state-chartered savings and loan association were "investment contracts" and, consequently, constituted "securities" under the 1934 Act. The Court noted that the term "security" " 'embodies a flexible rather than static principle . . .' " 389 U.S. at 338.

Giving the definition of "security" this liberal reading, a certificate of deposit issued for cash by a bank could be considered the equivalent of an "evidence of indebtedness" and would be a "security" within the meaning of the 1933 Act.

The 1934 Act, however, does not include the term "evidence of indebtedness" in the statutory definition. Conceivably, a certificate of deposit issued for cash by a bank might be deemed an "investment contract" or more likely a "note". But the specific exclusion of "any note, draft, bill of exchange, or banker's acceptance" having a maturity of nine months or less from the definition under the 1934 Act, would appear applicable to a six-months' certificate

of deposit issued for cash by a bank and which evidences a time deposit made at the issuing bank.

DOES THE COMPLAINT ALLEGE FACTS CONSTITUTING A VIOLATION OF THE SECURITIES ACTS?

The Court has expressed its conclusion that plaintiff lacks standing to maintain an action for fraud in connection with the purchase or sale of the Manhattan shares and the three certificates of deposit. Were the Court to follow the consequences of this legal conclusion as to standing, it would be unnecessary for the Court to decide the question of whether the acts charged in the complaint with respect to these particular transactions constitute violations of section 17(a) of the 1933 Act and section 10(b) of the 1934 Act.

However, as the Court has also concluded, plaintiff does have standing to maintain an action alleging fraud in connection with the sale of Manhattan's portfolio of United States Government securities. Consequently, the Court must consider whether the acts charged in the complaint constitute violations of section 17(a) of the 1933 Act and section 10(b) of the 1934 Act with respect to that particular security transaction.

Plaintiff contends that there was but one pervasive fraudulent scheme, and that all of the various security transactions and other financial manoeuvres were interrelated and cumulative. Since the Court must, for present purposes, accept the allegations of the complaint as true, the Court will determine whether the complaint, considered as a whole, charges conduct which violates section 17(a) of the 1933 Act or section 10(b) of the 1934 Act. Therefore, the Court's discussion will be directed to the complaint as a whole and be general in terms. The Court holds that the

allegations of fraud in connection with the sale of Manhattan's portfolio of United States Government securities do no charge conduct violative of the securities acts. The rationale underlying that holding applies equally to the allegations of fraud in connection with the purchase and sale of the Manhattan shares, that is, such allegations do not charge conduct violative of the securities acts. Similarly, if it be assumed that the three certificates of deposit herein constitute "securities" within the meaning of the securities acts, such rationale demonstrates that the allegations of fraud in connection with the purchase of said certificates of deposit do not charge conduct violative of the securities acts.

The gravamen of the complaint is the diminution in Manhattan's assets. This diversion or misappropriation of assets apparently was the essence of the fraud. The allegations describing subsequent conduct charge only that they were designed to conceal the defendants' misdeeds in a maze of numerous intricate and confusing transactions.

A viable claim under Rule 10b-5[15] requires that there have been fraud or deception in connection with the purchase or sale of securities. In interpreting the phrase "in connection with the purchase or sale of any security," it would be relevant to discuss the purpose of the Congressional enactments, and, in so doing, to consider whether the alleged fraud could result in the abuses sought to be curbed or prevented and whether the fraudulent activity otherwise touched on any federal concern.

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[15] On the premise that the more liberal language of Rule 10b-5 is an indication that its scope is more expansive than that of section 17(a) of the 1933 Act, the Court will discuss this issue only in terms of Rule 10b-5. If no claim is established under Rule 10b-5, *a fortiori*, none would exist under section 17(a) of the 1933 Act.

The securities acts, and especially the 1934 Act, were intended to prevent fraud and deception, manipulation and inadequate disclosure in the dissemination and trading of securities. The securities acts are not so much concerned with fraud *per se* as with the effect of fraud upon investors and the public interest in maintaining free and open securities markets. 1934 Act §2(3), 15 U.S.C. §78b(3); *Schoenbaum* v. *Firstbrook*, 405 F.2d 200, 212 (2d Cir.), *rev'd en banc*, 405 F.2d 215 (2d Cir. 1968); *S.E.C.* v. *Texas Gulf Sulpher Co.*, 401 F.2d 833, 858-60 (2d Cir., *en banc*, 1968); *cf. A.T. Brod & Co.* v. *Perlow, supra.*

In order to sustain a complaint alleging fraud under section 10(b) of the 1934 Act, it must appear with reasonable clarity from the face of the complaint either (1) that a purchase or sale of securities is at the crux of a fraudulent scheme; or (2) that inducing a purchase or sale of securities is the object of a fraudulent scheme; or (3) that fraudulent statements, misstatements, or omissions are made in a manner which is reasonably calculated to influence the investing public, or are of the sort which the reasonable investing public might rely upon; or (4) that the trading process is abused through potential market manipulation or the spread of watered stock.

The purity of the security transaction and the purity of the trading process are the sole objectives of federal concern. Therefore, the consummation of a security transaction as a mere incident of a fraudulent scheme and the mere fact of injury caused by the fraud, in the absence of any possibility that the fraud might materially affect the purity of the security transaction and the purity of the trading process would not make the fraud federally cognizable. *Cf. O'Neill* v. *Maytag*, 230 F.Supp. 235, 239 (S.D. N.Y.), *aff'd*, 339 F.2d 764 (2d Cir. 1964).

Giving the unique factual allegations of the complaint a most liberal reading, the Court concludes that plaintiff was not the victim of "federal fraud" as defined above.[16] A federal claim is not pleaded by allegations that, in the course of a scheme to loot a corporation of its assets, certain security transactions occurred, when these transactions—though contaminated by the overriding evil intent to accomplish the ultimate looting—did not involve fraud or deceit in connection with the sale or purchase of a security.

Manifestly, the sale of Manhattan's portfolio and the purchase of the Manhattan shares were necessary steps toward the ultimate looting of Manhattan's assets. But

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[16] The Court also declines to sustain the sufficiency of the complaint because the injury in this particular case (and thus the benefit of any recovery) was not incurred by anyone who was the subject of federal concern. In view of the unusual fact that the fraud was practiced not upon any member of the "decision-making body" of the corporation (*i.e.*, officers, directors, or shareholders), *see Globus, Inc.* v. *Jaroff*, 266 F.Supp. 524, 529 (S.D.N.Y. 1967); *Simon* v. *New Haven Board & Carton Co.*, 250 F.Supp. 297, 299 (D. Conn. 1966), but only upon creditors and policy holders, it is dubious whether plaintiff corporation was ever defrauded or deceived.

Doubtless, a corporation may be deceived or defrauded even if every member of the board of directors was fully informed of the true facts (or, in factual situations similar to this case, that all of the directors were participants in the scheme). *Schoenbaum* v. *Firstbrook*, 405 F.2d 215 (2d Cir. *en banc*, 1968); *Continental Bank & Trust Co.* v. *Garfinkle*, 292 F.Supp. 709 (S.D.N.Y. 1968). But, as is evident from Judge Hays' dissenting opinion in the three-judge panel decision in *Schoenbaum* v. *Firstbrook*, *supra* (Judge Hays, significantly, having also authored the *en banc* majority opinion reversing the three-judge panel's decision), in such a case, there must be a showing that the directors deceived the shareholders—"the real owners of the property with which the directors were dealing." 405 F.2d at 215.

The highly individualized circumstance present in the case at bar—the lack of injury to shareholders—intensifies the Court's reluctance to hold that the complaint states a claim of federal fraud.

Rule 10b-5 requires the employment of fraud in connection with a security transaction, which is essentially different from the effectuation of a security transaction in connection with a fraudulent activity.[16a]

The complaint, taken as a whole, alleges no more than a common law action for misappropriation of corporate funds by a fiduciary, embezzlement or fraudulent conveyance perhaps, or the distribution of an illegal dividend. None of these actions, in the absence of diversity of citizenship, can be maintained in a federal court.

Ruckle v. *Roto American Corp.*, 339 F.2d 24 (2d Cir. 1964) and *Schoenbaum* v. *Firstbrook*, 405 F.2d 415 (2d Cir., *en banc*, 1968) do not hold otherwise. In *Ruckle*, the corporation proposed to issue its own shares to the president for a less than adequate consideration. A majority

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[16a] The distinction here drawn can be best illustrated by analogy to the general conspiracy statute, 18 U.S.C. §371 (1964), which makes unlawful a conspiracy when one or more of the members of the conspiracy "do any act to effect the object of the conspiracy." In order for conduct to qualify as an overt act under that statute, the conduct need not, of itself, be unlawful, provided it was done to effect the object of the conspiracy. Nevertheless, unless the act done in furtherance of the conspiracy was itself unlawful, although committed for the purpose of furthering the object of the conspiracy, the overt act may not serve as the basis for a criminal prosecution for a substantive crime.

Similarly, in this case, the various security transactions were overt acts committed for the purpose of promoting and effecting the object of the fraudulent conspiracy (*e.g.*, the sale of Manhattan's portfolio of United States Government securities was necessary to effectuate the looting of Manhattan's assets). However, unless such security transactions were independently unlawful—*i.e.*, unless there was fraud in connection with the purchase or sale of a security—they could not serve as the basis for a substantive claim under section 10(b) and Rule 10b-5. As pleaded, the security transactions themselves, when considered from the viewpoint of section 10(b) and Rule 10b-5, were innocuous though constituting overt acts furthering the fraudulent scheme. Consequently, they cannot serve as the independent predicate for liability under section 10(b) and Rule 10b-5.

of the board withheld material information from one of the directors before approval was voted. The court held that the issuance would constitute a violation of Rule 10b-5.

In *Schoenbaum,* the court held that the issuance of stock by a corporation to its controlling stockholder at "vastly inadequate prices," apparently with each board member having full knowledge of the inadequacies (all were named as co-conspirators and defendants), stated a claim for relief under section 10(b) and Rule 10b-5.

The crucial facts in these cases were that, in each, the "fraudulent practice" was deception (whether of directors or shareholders) which directly resulted in the issuance of stock for inadequate consideration, thus creating the danger of the spread of "thin" or "watered" stock. The direct involvement of the deceit with a transaction of securities is fraud "in connection with" the sale of stock, and, consequently, constitutes federal fraud irrespective of whether it also constitutes corporate mismangement. As the three-judge panel in *Schoenbaum* v. *Firstbrook, supra,* stated: "A fraud upon a corporation which has the effect of depriving it of fair consideration for the issuance of its stock would necessarily have the effect of reducing the equity of the corporation's shareholders and this reduction in equity would be reflected in lower prices bid for the shares on the domestic stock market." 405 F.2d at 208.

The facts in the instant case, on the contrary, could not give rise to any of these dangers and do not evidence that the fraud was rooted in a security transaction.

That the complaint in this case states no more than a non-federal common law cause of action becomes even more evident upon consideration of the factual situation and language of the Court of Appeals in *Mutual Shares Corp.*

v. *Genesco, Inc.*, 384 F.2d 540 (2d Cir. 1967). Plaintiffs there alleged, *inter alia*, that defendant Genesco, a 94% stockholder in S.H. Kress & Co. had acquired its shares pursuant to a fraudulent conspirary, the purpose of which was to finance its purchases of Kress stock from Kress' own assets and to manage Kress for Genesco's own benefit, appropriating Kress' assets in the meanwhile. After holding that plaintiffs could not maintain an action charging violations of Rule 10b-5 occurring before plaintiffs had acquired their shares, the court stated (as to the period subsequent to plaintiffs' acquisition of shareholder status) that the "fraudulent activities then alleged are primarily corporate abuse and diversion, claims cognizable under state law but not under the Act." 384 F.2d at 546. Only the claim that defendants had "manipulated the market price of Kress stock, keeping dividends to a minimum, in order to force minority shareholders to sell out to Genesco at depressed values," *id.*, stated a good cause of action under Rule 10b-5.

The complaint in this case also fails to allege any actual or potential abuse of the trading process. Since public distribution of watered or valueless stock was not a part of the scheme, and the fraud had no potential manipulative effect on the market, and did not raise the spectre of any other evil which prompted passage of the securities acts or is a subject of federal concern, the factual situation in the instant case differs significantly from those in the cases plaintiff cites as major support for sustaining the validity of its claim.

A.T. Brod & Co. v. *Perlow, supra,* explicitly found that the fraud was federally cognizable because it had a "potentially manipulative effect on the securities market." 375 F.2nd at 397.

Hooper v. *Mountain States Securities Corp.*, 282 F.2d 195 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961), is also stressed heavily by plaintiff. In that case, an individual named Cage was required to sever his connection with the plaintiff corporation (the nominal plaintiff was the corporation's trustee in bankruptcy) when a new group acquired control. Cage concocted a scheme whereby he induced the plaintiff's transfer agent to issue new shares with a market value of about $700,000 after transferring to the corporation worthless contract rights. The actual fraud appeared to be the false representations made to the transfer agent by certain former officers of the corporation and the phony corporate documents prepared to justify and legitimize the issuance of stock. The scheme also involved the distribution by Cage and his cohorts of this newly issued stock over security markets to unwary members of the investing public. Because the purpose and object of the scheme were to have valuable corporate stock issued to Cage (actually to another corporation controlled by Cage which was liquidated immediately after receiving the stock) in exchange for worthless consideration, and then to distribute the stock publicly, the fraud was definitely "in connection with" the purchase and sale of securities. The scheme induced an unfair sale of securities and it had as a major purpose the spread of watered stock to many investors.

In *Pettit* v. *The American Stock Exchange*, 217 F.Supp. 21 (S.D.N.Y. 1963), a similar scheme was perpetrated when huge amounts of Swan-Finch stock was issued, through various corporate shells, for worthless consideration, and then distributed over the American Stock Exchange. That court noted that the fraud violated Rule 10b-5 because the transaction represented an "abuse of the securities trading process," and because the "heart of this case are two fraudulent transactions in securities." 217 F.Supp. at 25-26.

Each security transaction herein was effected for full and fair consideration with full knowledge in both purchaser and seller as to the value of the securities sold. Where this has occurred Rule 10b-5 is not violated. *See Fleischer, "Federal Corporation Law": An Assessment,* 78 Harv. L. Rev. 1146, 1166 (1965). Only where the security transaction was a "vital aspect of a continuing scheme," should the fact of subsequent misappropriation of the consideration result in a violation of Rule 10b-5. *Compare Cooper* v. *North Jersey Trust Co.,* 226 F.Supp. 972, 978 (S.D.N.Y. 1964), *with S.E.C.* v. *Fifth Avenue Coach Lines, Inc.,* 289 F.Supp. 3, 36-39 (S.D.N.Y. 1968).

The complaint in this case presents no more than a complicated scheme of common law fraud.[17]

Discovery herein has been extensive. The parties have not called to the Court's attention any facts which were not alleged in the complaint and which would, if leave to amend the complaint were granted, state a cause of action under the securities acts. Accordingly, the Court hereby dismisses the complaint as to the movants and hereby directs that judgment be entered for movants. Fed. R. Civ. P. 54(b).

So ordered.

Dated: New York, N. Y.
June 3, 1969.

/s/ WILLIAM B. HERLANDS
William B. Herlands
U.S.D.J.

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[17] Plaintiff instituted such a common law action in New York County Supreme Court in 1965. After joinder of issue, further proceedings in the action were enjoined. The factual allegations of the complaint filed in the state court proceeding are essentially the same as those contained in the complaint herein.

Opinion, Ryan, J., Dismissing the Complaint

[SAME TITLE]

Jurisdiction of the Court to entertain this action is now directly challenged in motions to dismiss made by defendant IRVING TRUST COMPANY and by defendants GARVIN, BANTEL & COMPANY and GEORGE K. GARVIN. (See our memorandum endorsement of June 19, 1968.)

Diversity jurisdiction is not present.

Plaintiff urges that, although the complaint alleges that jurisdiction over the subject matter is based on violations of Section 17A of the Securities Exchange Act of 1933 (15 U.S.C. 77q(a)), jurisdiction also exists under Section 10(b) of the 1934 Act and S.E.C. Rule 10b-5.

Plaintiff was neither a defrauded purchaser nor seller, and he may not plead a claim under Section 10(b) of the 1934 Act and S.E.C. Rule 10b-5. Judge Herlands so held granting the Bankers Life motion to dismiss for lack of jurisdiction (See Judge Herlands' opinion of June 3, 1969). I agree.

The complaint does allege fraud in connection with the sale of Manhattan's U.S. Government securities. The fraud charges was not in violation of the Securities Acts of either 1933 or 1934. The fraud alleged was not in the purchase or sale of securities, but was waste of Manhattan's assets by diversion and misappropriation of its securities. I agree with Judge Herlands that "the complaint in this case presents no more than a complicated scheme of common law fraud" over which there is no independent federal jurisdiction.

Opinion, Ryan, J., Dismissing the Complaint

Motions to dismiss are granted without prejudice to prosecution of the action plaintiff filed and is pending in the Supreme Court, County of New York. Settle appropriate order directing entry of such judgment.

Dated: June 9, 1969.

/s/ SYLVESTER J. RYAN
Sylvester J. Ryan
U.S.D.J.

Judgment Dismissing Complaint as to Bankers Life and Casualty Company, Belgian American Banking Corporation and Belgian American Bank and Trust Company

[SAME TITLE]

The defendants Bankers Life and Casualty Company, Belgian American Banking Corporation and Belgian American Bank & Trust Company, having moved to dismiss the complaint as to them on the grounds (1) for lack of jurisdiction over the subject matter (2) that the complaint fails to state a claim upon which relief can be granted, and (3) plaintiff lacks the requisite standing to recover damages for alleged violations of the 1933 and 1934 Acts, and the said motions having come on to be heard before the Honorable William B. Herlands, United States District Judge, and the Court thereafter on June 3, 1969, having handed down its opinion decision granting the motions and dismissing the complaint as to said defendants for failure to state a cause of action under the securities acts, and the Court having pursuant to Rule 54(b) Federal Rules of Civil Procedure expressly detrmined that there is no just reason for delay of entry of this judgment, it is,

ORDERED, ADJUDGED AND DECREED: That the defendants Bankers Life and Casualty Company, Belgian American Banking Corporation and Belgian American Bank and Trust Company have judgment against the plaintiff Superintendent of Insurance of the State of New York, as Liq-

Judgment Dismissing Complaint as to Bankers Life and Casualty Company, Belgian American Banking Corporation and Belgian American Bank and Trust Company

uidator of Manhattan Casualty Company dismissing the complaint as to them.

Dated: New York, N.Y.
June 4, 1969

/s/ WILLIAM B. HERLANDS
William B. Herlands
U.S.D.J.

JUDGMENT ENTERED: 6-4-69

/s/ JOHN LIVINGSTON
John Livingston
Clerk

Judgment Dismissing Complaint as to Irving Trust Company

[SAME TITLE]

Defendant, Irving Trust Company, having moved for an order pursuant to Rules 12(c) and 12(h) of the Federal Rules of Civil Procedure dismissing the complaint herein as against defendant Irving Trust Company, directing the entry of final judgment, and the granting of such other and further relief as the Court may deem just and proper, on the grounds that (1) the Court does not have jurisdiction over the subject matter of this action, and (2) the complaint fails to state any claim upon which relief can be granted, and the said motion having come on to be heard before the Honorable Sylvester J. Ryan, United States District Judge, and the Court thereafter, on June 9, 1969, having handed down its decision granting said motion and dismissing the complaint as to defendant Irving Trust Company, and pursuant to Rule 54b of the Federal Rules of Civil Procedure, it being expressly determined that there is no just reason for delay, it is

ORDERED, that the Clerk enter judgment against the plaintiff, the Superintendent of Insurance of the State of New York, as Liquidator of Manhattan Casualty Company dismissing the complaint against defendant Irving Trust Company for lack of jurisdiction; and it is further

ORDERED, that the dismissal of the complaint herein is without prejudice to the prosecution of the action that the

Judgment Dismissing Complaint as to Irving Trust Company

Superintendent of Insurance, as Liquidator of Manhattan Casualty Company, has commenced in the Supreme Court, County of New York.

Dated: New York, New York
June 16, 1969.

/s/ SYLVESTER J. RYAN
Sylvester J. Ryan
U.S.D.J.

Judgment Dismissing Complaint as to Garvin, Bantel & Company and George K. Garvin

[SAME TITLE]

Defendants Garvin, Bantel & Company and George K. Garvin, having moved for an order pursuant to Rules 12(c) and 12(h) of the Federal Rules of Civil Procedure dismissing the complaint herein as against said defendants on the grounds that: (1) the Court does not have jurisdiction over the subject matter of this action and (2) the complaint fails to state a claim upon which relief can be granted, and said motion having come on to be heard before Honorable Sylvester J. Ryan, United States District Judge, and the Court on June 9, 1969 having handed down its decision granting said motion, it is

ORDERED, that the clerk enter judgment against plaintiff dismissing the complaint against defendants Garvin, Bantel & Company and George K. Garvin for lack of jurisdiction, and it is further

ORDERED, that the within motion to dismiss is granted without prejudice to the prosecution of the action plaintiff has commenced in the Supreme Court, County of New York.

Dated: New York, New York
June 17, 1969

/S/ SYLVESTER J. RYAN
U.S.D.J.

Judgment Entered 6-24-69

/S/JOHN LIVINGSTON, *Clerk*

Notice of Appeal

[SAME TITLE]

Notice is hereby given that the Superintendent of Insurance of the State of New York as Liquidator of Manhattan Casualty Company, plaintiff above named, hereby appeals to the United States Court of Appeals for the Second Circuit from:

1. The order granting the motion of defendants Bankers Life and Casualty Company, Belgian American Banking Corporation and Belgian American Bank & Trust Company to dismiss the complaint and the judgment entered thereon on the 4th day of June, 1969;

2. The order granting the motion of defendant Irving Trust Company to dismiss the complaint pursuant to Rules 12(c) and 12(h) of the Federal Rules of Civil Procedure and the judgment entered thereon on the 17th day of June, 1969; and

3. The order granting the motion of defendants Garvin, Bantel & Company and George K. Garvin to dismiss the complaint pursuant to Rules 12(c) and 12(h) of the Federal Rules of Civil Procedure and the judgment entered thereon on the 23rd day of June, 1969.

Dated: New York, New York
June 27, 1969

ARNOLD BAUMAN

Opinion of the Court of Appeals Affirming the Dismissals of the Complaint

[SAME TITLE]

BLUMENFELD, *District Judge*:

Appellant Superintendent of Insurance of the State of New York, as Liquidator of Manhattan Casualty Company (Manhattan), commenced this action in 1963 alleging violations by ten defendants of § 17(a) of the Securities Act of 1933. On September 10, 1968, defendants Bankers Life and Casualty Company (Bankers Life), Belgian American Bank & Trust Company (Belgian Trust), and Belgian American Banking Corporation (Belgian Banking) moved to dismiss the action before the late Judge Herlands. On October 1, 1968, defendants Irving Trust Company (Irving), Garvin, Bantel & Company (Garvin, Bantel), and George K. Garvin made similar motions before Judge Ryan. On June 4, 1969, Judge Herlands entered judgment dismissing the action as to Bankers Life, Belgian Trust, and Belgian Banking. His thorough and considered decision granting the motions of these defendants is set out at 300 F. Supp. 1083 (S.D.N.Y. 1969). Shortly thereafter, on June 17, 1969, Judge Ryan, concurring in the reasoning of Judge Herlands' opinion, entered judgment dismissing the action as to Irving, Garvin, Bantel, and George K. Garvin. It is from these judgments that the Superintendent appeals. We affirm.

Opinion of the Court of Appeals Affirming the Dismissals of the Complaint

I. *Facts*

Manhattan was a casualty insurance company wholly owned by defendant Bankers Life and operated by it as a subsidiary. In January 1962 two individuals, defendants Standish T. Bourne and James F. Begole, both now deceased, and not involved in this appeal, agreed to purchase all the stock of Manhattan. On January 19, 1962, a contract was executed between Begole as purchaser and Bankers Life as seller, providing for the sale of the Manhattan stock for $5,000,000 on January 24, 1962. On that day, Begole, John F. Sweeny[1] and C. Joseph Gunter, an officer of Irving, went to Manhattan's office for the closing. Pursuant to plans made in advance of the closing, Gunter tendered an Irving check for $5,000,000 to an officer of Bankers Life and, in exchange, all of the shares of Manhattan stock were given to Begole.

This transaction between Bankers Life and Begole still remains unchallenged because neither the former, as seller, nor the latter, as buyer, has brought any action seeking damages or any relief, one against the other. In this lawsuit our attention has been shifted away from that conventional purchase and sale of the Manhattan stock to the

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[1] At oral argument in the district court, it was learned that Manhattan ousted Sweeny from the presidency of Manhattan at about the time that Bankers Life decided to sell the Manhattan stock, and that subsequent to the ouster Sweeny established contact between Begole and Bourne and Bankers Life. Judge Herlands concluded:

> "Probably at that time, Sweeny also arranged with Begole and Bourne that he should be reinstated as president of Manhattan when, and if, Begole and Bourne acquired control of Manhattan." 300 F. Supp. at 1087 and n. 4.

legerdemain employed by the buyer to obtain the $5,000,000 with which to pay for the stock.[2]

Following the closing, but on the same day, United States Government securities (Treasury bonds) from Manhattan's portfolio were sold[3] and the proceeds, amounting to $4,854,552.67, plus enough cash to bring the total to $5,000,000, were credited to an account in the name of Man-

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[2] The details of financing the purchase of Manhattan stock were apparently the responsibility of Bourne. He engaged the services of defendant George K. Garvin and the latter's firm of money brokers (Garvin, Bantel), who had arranged in advance for the above transaction as well as those to follow.

[3] The complaint is silent as to the source of authority for this sale of securities from Manhattan's portfolio. Noting that fact, Judge Herlands stated:

> "Conceivably it was [Sweeny, apparently installed as president of Manhattan after the stock changed hands] who directed the Chemical Bank to deliver Manhattan's portfolio of . . . securities to Irving Trust, authorized the sale of these securities and then transferred Manhattan cash to Irving Trust in order to cover completely the $5,000,000 Irving Trust check payable to Bankers Life." 300 F. Supp. at 1089.

He also noted the possibility that a board of directors might have been named, which in turn met and appointed Sweeny as president and granted him authority to effect the transactions on Manhattan's behalf. *Id.* at 1089 n. 6.

Appellant vigorously contends that this represents a serious misunderstanding of fact vital to his theory of recovery. His contention is that the sale of Treasury bonds was authorized by resolution of the board of directors on the basis of a representation that the sale of bonds and purchase of a certificate of deposit was merely a change in the company's investment portfolio. Although every minute detail of the pretenses used by Begole and his associates to mask their fraudulent activity may not have been adduced from the complaint or from the other parts of the record as augmented after some six years of discovery, we are satisfied that the able district judges overlooked nothing that would affect the character of the claim.

hattan at Irving, and the $5,000,000 Irving check was then charged against this account. As a result of this first series of transactions, Bankers Life had received $5,000,000 in exchange for the Manhattan stock, Begole and Bourne owned the stock, and Manhattan's assets, having been used to purchase the Manhattan stock, had conesquently been reduced by $5,000,000.

In order the conceal the depletion of Manhattan's assets,[4] the individuals now in control of Manhattan had a neatly prepared ruse ready at hand. At Garvin's request, Irving issued a second check for $5,000,000 payable to Belgian Trust. Sweeny, president of Manhattan, used this check to buy a $5,000,000 six-month's certificate of deposit from Belgian Trust payable to Manhattan. That certificate was then endorsed by Sweeny as president of Manhattan to New England Note Corporation (New England) and delivered to Bourne, president of New England. Bourne then endorsed and delivered it to Belgian Banking as collateral for a six-month's $5,000,000 loan from Belgian Banking to New England. The proceeds of this loan were then delivered to Irving to cover its $5,000,000 check drawn to the order of Belgian Trust.

To recapitulate, there were two sets of telescoped transactions—all completed on the same day:

A. All of Manhattan's shares were purchased from Bankers Life for $5,000,000, borrowed from Irving. After

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[4] The financial ability of corporations engaged in the business of liability insurance to meet claims against its policyholders is subject to regulation under the laws of New York. Their books are open to regular inspection by experts in that business employed by the insurance department of the State of New York.

thus gaining control of Manhattan, the purchaser sold government bonds out of Manhattan's portfolio and used the proceeds to pay off the loan from Irving.

B. To conceal the above depletion of Manhattan's assets, the new owners of Manhattan and those they put in control arranged for a second loan from Irving for $5,000,000. With this they bought a $5,000,000 certificate of deposit from Belgian Trust in the name of Manhattan, and assigned that to New England (Bourne). New England endorsed it to Belgian Banking as security for a $5,000,000 loan to New England. The proceeds were then used to repay Irving's second loan. However, Manhattan's books reflected only the sale of its government bonds and the purchase of the certificate of deposit. Manhattan's records did not show (1) that the proceeds of the sale of these bonds were used by Begole to pay for his purchase of Manhattan's shares or (2) that the certificate of deposit had been assigned to New England and by it pledged to Belgian Banking.

The loans and certificates outlined in *B.* were twice renewed. The first renewal was in July 1962. In January 1963, when Belgian Banking refused to renew its loan to New England a similar round robin set of transactions was effected by substituting Marine Midland Trust Company to perform Belgian Banking's role. In April 1963 the New York Insurance Department discovered the inadequacy in Manhattan's assets and placed the company in liquidation.

II. *Appellant's Claims*

The complaint alleges that the foregoing related transactions constituted one or more violations of § 17(a) of

the 1933 Act, 15 U.S.C. § 77q(a).[5] The district court properly considered as well the applicability to the pleaded facts of § 10(b) of the 1934 Act, 15 U.S.C. § 78j(b)[6] and of S.E.C. Rule 10b-5[7] promulgated thereunder. See *Hoover* v. *Allen*,

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[5] Section 17(a) provides:

"It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

"(1) to employ any device, scheme, or artifice to defraud, or

"(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

"(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

[6] Section 10(b) provides:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * * * *

"(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

[7] Rule 10b-5 provides:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

"(1) to employ any device, scheme, or artifice to defraud,

"(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make

241 F. Supp. 213, 226 n. 7 (S.D.N.Y. 1965). On appeal, appellant claims the pleaded facts, as well as those otherwise contained in the record, establish his right to recover under one or both of these sections for fraud perpetrated (1) in connection with the purchase and sale of the Manhattan stock, (2) in connection with the sale of Treasury bonds from Manhattan's portfolio, and (3) in connection with transactions involving certificates of deposit and occurring after January 24, 1962. We disagree and affirm the decision of the district court.

III. *Sale of Manhattan Stock*

Section 17(a) of the 1933 Act provides a cause of action only for a defrauded purchaser. *Schoenbaum* v. *Firstbrook*, 268 F. Supp. 385, 396 (S.D.N.Y. 1967), *aff'd*, 405 F.2d 200 (2d Cir.), *rev'd in part on other grounds*, 405 F.2d 215 (2d Cir. 1968) (*en banc*), *cert. denied* sub nom. *Manley* v. *Schoenbaum*, 395 U.S. 906 (1969). Section 10(b) of the 1934 Act and Rule 10b-5 extend a similar right to a defrauded seller as well as to a purchaser of securities. *Greenstein* v. *Paul*, 400 F.2d 580, 581 (2d Cir. 1968); *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461, 463 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952); see *Christophides*

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the statements made, in the light of the circumstances under which they were made, not misleading, or

"(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

"in connection with the purchase or sale of any security."

v. *Porco*, 289 F. Supp. 403, 406 (S.D.N.Y. 1968).[8] Bankers Life was the seller of the Manhattan stock; Begole the purchaser. There is no theory under which Manhattan, in whose shoes this appellant stands, may be regarded as either the purchaser or the seller of Bankers Life's Manhattan stock. Consequently the appellant does not fall within the classes of those for whom a cause of action is created either by § 17(a) of the 1933 Act or § 10(b) of the 1934 Act for damages incurred as a result of that transaction.

IV. *Sale of Manhattan's Treasury Bonds*

Another thrust of this appeal is that the district court erred in holding that no federal cause of action was stated with respect to the purchase or sale of Treasury bonds from Manhattan's portfolio. Appellant's claim that Manhattan is entitled to federal relief as the defrauded seller of those bonds was presented to the district court only as "amendatory allegations presented in open court and not formally set forth in the complaint." 300 F. Supp. at 1098. Moreover, the alleged facts presented in support of the claim on appeal do not appear anywhere in the complaint.

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[8] Although there has been some judicial expansion of the category of persons who may be considered "purchasers," cf. *A. T. Brod & Co.* v. *Perlow*, 375 F.2d 393 (2d Cir. 1967), or "sellers" see *Vine* v. *Beneficial Fin. Co.*, 374 F.2d 627 (2d Cir.), *cert. denied*, 389 U.S. 970 (1967); *Hooper* v. *Mountain States Sec. Corp.*, 282 F.2d 195 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961), nothing in the cited cases undermines the now well-settled purchaser-seller rule in *Birnbaum*, especially in view of its recent reaffirmation in *Greenstein*. But see, *Weitzen* v. *Kearns*, 271 F. Supp. 616, 622 (S.D.N.Y. 1967); *Entel* v. *Allen*, 270 F. Supp. 60, 69 (S.D.N.Y. 1967).

See note 3, *supra*. Assuming that they are properly before us, and also that they are true, *Kossick* v. *United Fruit Co.*, 365 U.S. 731, 732 (1961), we hold that appellant has not made out a claim cognizable under the federal Securities Acts.

Briefly stated, appellant's claim is that a majority of the board of directors of Manhattan was deceived by misrepresentations of other members of the board and some of the defendants that the sale of the bonds was intended only to effectuate a substitution of those assets for a certificate of deposit equal in value; that in fact the certificate of deposit so substituted was collateralized to its full face value in favor of an unrelated corporate entity; and that on the basis of the fraudulent representations, the board was deceitfully induced to authorize the sale of the bonds in exchange for a certificate without value to the corporation.

What distinguishes the fraud perpetrated on Manhattan in this case from one cognizable under Rule 10b-5 is that its sole object was to obtain possession of Manhattan's government bonds for the personal use of the perpetrators. No doubt the deception was successful, for had the board known that Sweeny and his associates intended to misappropriate the proceeds for their own use it undoubtedly would not have authorized their sale. But that deception did not infect the subsequent sales transaction. With respect to the terms of the sale itself neither the purchaser nor the seller of the bonds was deceived or defrauded. Cf. *Ruckle* v. *Roto Am. Corp.*, 339 F.2d 24 (2d Cir. 1964); *Globus, Inc.* v. *Jaroff*, 266 F. Supp. 524 (S.D.N.Y. 1967); *Simon* v. *New Haven Board & Carton Co.*, 250 F. Supp. 297 (D. Conn. 1966). Indeed, it is no part of the liquida-

tor's claim that the full and fair market price was not paid for those bonds by their purchaser. The fraud which harmed the plaintiff consisted of the failure of Sweeny and his associates to account for the proceeds. There is a structural difference between the sale of the corporation's bonds at a concededly fair price and the subsequent fraudulent misappropriation of the proceeds received.

Rule 10b-5 was not intended to provide a remedy for schemes amounting to no more than "fraudulent mismanagement of corporate affairs." *Birnbaum* v. *Newport Steel Corp., supra,* 193 F.2d at 464. The scope of the rule must be assessed in light of the purposes of the legislation from which it derives, which we recently found to be "to promote free and open public securities markets and to protect the investing public from suffering inequities in trading . . ." *SEC* v. *Texas Gulf Sulphur Co.,* 401 F.2d 833, 858 (2d Cir. 1968) (*en banc*), *cert. denied* sub nom. *Coates* v. *SEC,* 394 U.S. 976 (1969). In that case, we construed the "in connection with" requirement of Rule 10b-5 as follows:

> "Therefore it seems clear from the legislative purpose Congress expressed in the Act, and the legislative history of Section 10(b) that Congress when it used the phrase 'in connection with the purchase or sale of any security' intended only that the device employed, whatever it might be, be of a sort that would cause reasonable investors to rely thereon, and, in connection therewith, so relying, cause them to purchase or sell a corporation's securities." *Id.* at 860.

See *Heit* v. *Weitzen,* 402 F.2d 909, 913 (2d Cir. 1968), *cert. denied,* 395 U.S. 903 (1969).

Opinion of the Court of Appeals Affirming the Dismissals of the Complaint

The fraud alleged in this case in no way affected either the securities markets or the investing public. No stockholders were defrauded, no investor injured. The purity of the security transaction and the purity of the trading process were unsullied. There was no danger that the securities sold would be overvalued on reaching the public markets. Cf. *Ruckle* v. *Roto Am. Corp., supra,* 339 F.2d at 28.

Despite the power of the Commission to promulgate rules "appropriate in the public interest or for the protection of investors," § 78j(b), the scope of the rule in fact promulgated is expressly limited to protection against fraud or deceit "in connection with the purchase or sale of any security." Rule 10b-5. Although in the broadest sense the public interest is involved when a corporation which is subject to regulation by the state Superintendent of Insurance is defrauded, the public interest cognizable by § 10(b) is limited to preserving the integrity of the securities markets. The civil liberties provisions of the federal Securities Acts, beginning in 15 U.S.C. § 77(*l*) were "part of a broad integrated program designed to obtain honest dealings in securities," *Wilko* v. *Swan,* 127 F. Supp. 55, 58 (S.D.N.Y. 1955), not one to create an unlimited federal right of action for damages for all who have been defrauded in any area of economic activity. The condition imposed by Rule 10b-5 that the fraud be in connection with the purchase or sale of a security is wholly consistent with that program. Thus, we do not decide that the creditors of Manhattan do not have any remedy under general state tort law for the fraud practiced on their debtor, but only that the federal Securities Acts have not provided a federal forum for its enforcement.

Opinion of the Court of Appeals Affirming the Dismissals of the Complaint

V. *Transactions Involving Certificates of Deposit*

Appellant also contends that Manhattan was defrauded in connection with both purchases and sales of various six-month certificates of deposit exchanged after January 24, 1962. These transactions, which were integral parts of the scheme[9] to conceal the prior depletion of Manhattan's assets, are sufficiently described in the opinion below and need not be fully restated here. The conclusion we have reached that the sale of Manhattan's Treasury bonds did not present a federal cause of action applies equally to these transactions. The certificates of deposit or their proceeds may have been fraudulently misapplied, but there was no fraud in connection with their purchase or sale. In each instance they were bought and sold for their full face amount.

Since we have considered those facts appellant would include in an amendment of his complaint in reaching our conclusion that a claim for relief under the federal Securities Acts is not alleged, we also affirm the district court's denial of the motion to amend.

Affirmed.

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[9] Although the plaintiff contends that it is clear that liability would attach at any one of a number of junctures along the path that led to the liquidation of Manhattan, it expressly disclaims the right to separate recoveries for each of these "separate and distinct fraudulent schemes."

Opinion of the Court of Appeals Affirming the Dismissals of the Complaint

HAYS, *Circuit Judge* (dissenting):

Plaintiff has succeeded to all the rights of Manhattan and is the proper person to assert those rights. See *Hooper* v. *Mountain States Securities Corp.*, 282 F.2d 195, 206-07 (5th Cir. 1960), cert. denied, 365 U.S. 814 (1961), where plaintiff was the defrauded corporation's trustee in bankruptcy.

Manhattan was the victim of a "scheme . . . to defraud" (Rule 10b-5). Judge Blumenfeld has adequately described that scheme. Since the vital center of the scheme, the vehicle for the perpetration of the fraud, was the sale of Manhattan's stock, it seems to me to be completely unrealistic to say that the fraud was not committed "in connection with the purchase or sale of any security."

This court has repeatedly indicated its intention to give a broad and liberal interpretation to Rule 10b-5 in order to assure that that provision is used to accomplish the beneficient purposes for which the statutes governing sales of securities were enacted. See *Ruckle* v. *Roto American Corp.*, 339 F.2d 24 (2d Cir. 1964); *Vine* v. *Beneficial Finance Co.*, 374 F.2d 627 (2d Cir.), cert. denied, 389 U.S. 970 (1967); *A. T. Brod & Co.* v. *Perlow*, 375 F.2d 393 (2d Cir. 1967); *S.E.C.* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (*en banc*), cert. denied sub nom. *Coates* v. *S.E.C.*, 394 U.S. 976 (1969); *Schoenbaum* v. *Firstbrook*, 405 F.2d 215 (2d Cir. 1968) (*en banc*), cert. denied sub nom. *Manley* v. *Schoenbaum*, 395 U.S. 906 (1969); *S.E.C.* v. *Great American Industries, Inc.*, 407 F.2d 453 (2d Cir. 1968) (*en banc*), cert. denied, 395 U.S. 920 (1969). In our most recent expression on the subject, we said that "[t]he purchase-sale requirement must be interpreted so that the

broad design [of the statutes] . . . is not frustrated by the use of novel or atypical methods" and we quoted from *S.E.C.* v. *Texas Gulf Sulphur, supra,* the following language *inter alia*: "the courts, as they should, have broadly construed the statutory phrase 'in connection with the purchase or sale of any security.'" *Crane Co.* v. *Westinghouse Air Brake Co.*, 419 F.2d 787, 798 & n. 14 (1969).

In my opinion, the purposes of the statutes would be best accomplished here by recognizing plaintiff's standing to enforce the duties created by those statutes.

Judgment of the Court of Appeals Affirming the Dismissals of the Complaint

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the twenty-second day of July one thousand nine hundred and seventy.

Present:

HON. J. EDWARD LUMBARD,
Chief Judge

HON. PAUL R. HAYS,
Circuit Judge

HON. M. JOSEPH BLUMENFELD,
District Judge

[SAME TITLE]

Appeal from the United States District Court for the Southern District of New York.

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the judgments and order of said District Court be and they hereby are affirmed with costs to be taxed against the appellant.

/s/ A. DANIEL FUSARO
Clerk

Filed: July 22, 1970

Order of the Court of Appeals Denying Petition for Rehearing

[SAME TITLE]

A petition for a rehearing having been filed herein by counsel for the appellant,

Upon consideration thereof, it is

Ordered that said petition be and it hereby is DENIED.

.....

J. EDWARD LUMBARD

.....

M. JOSEPH BLUMENFELD
per J.E.L.

.....

I dissent and vote for rehearing

/s/ PAUL R. HAYS

September 30, 1970

Order of the Court of Appeals Denying Petition for Rehearing *In Banc*

[SAME TITLE]

A petition for a rehearing containing a suggestion that the action be reheard in banc having been filed herein by counsel for the appellant and no active circuit judge having requested that a vote be taken on said suggestion,

Upon consideration thereof, it is

Ordered that said petition be and it hereby is denied.

J. EDWARD LUMBARD
Chief Judge

September 30, 1970

Order of the Supreme Court of the United States Allowing Certiorari

[SAME TITLE]

ORDER ALLOWING CERTIORARI. Filed March 22, 1971.

The petition herein for a writ of certiorari to the United States Court of Appeals for the Second Circuit is granted.

Alexander Kosloff, Insurance Department Hearings

• • • • •

[24] Q. Let me run through this step by step and perhaps we can reconstruct it. Were you familiar with the sale of U. S. Government obligations by Manhattan Casualty before January 1, 1962, or during the month of January 1962? A. I was familiar to this degree, that as a member of the Board of Directors I, together with the rest of the Board, voted approval of a resolution to sell Government obligations to the extent of $5 million dollars and to deposit them under a CD with the Belgian American Bank.

Q. Were you aware that the resolution called for the deposit of these funds in the Belgian American Trust Company? A. Yes, that was the resolution we voted.

• • • • •

Sanford Peyton Stallworth,
Insurance Department Hearings

• • • • •

[131] . . . Was there any discussion amongst you members of the Board of Directors as to why the company was putting $5 million dollars in to Belgian American Bank & Trust Company? A. No. It was merely an investment per se, and I knew it was a good investment.

• • • • •

Q. That $5 million dollars came, you say, either from mortgages or Government bonds, but it came from the sale of some securities of the Manhattan Casualty Company, is that right? A. That's right, yes.

Edgar Bloch, Insurance Department Hearings

* * * * *

[51] Q. Why were the government bonds sold in January of '62? A. Well what was brought forth at that Directors' meeting was that it was anticipated the government would come out with a 5% bond and the purpose of selling the lower [52] coupon bonds and putting the money in a certificate of deposit was to put the company in a position to invest in the 5% bond if it became available.

Q. Who made that statement? A. Well it was proposed either by Mr. Begole or Mr. Sweeny, I am not sure, I think it was Mr. Begole.

* * * * *

[54] Mr. Perrotta: This is a statement by Mr. Bloch in answer to a question by Mr. Oster who at the meeting of the Board of Directors in January of 1962 was actively supporting the resolution for the purchase of time deposits from the Belgian American Bank.

Witness: My recollection is that it was Mr. Begole.

Samuel Adams, Deposition

* * * * *

[72] Mr. Marcheso: Would you identify the exhibits that you were reading from?

A. Exhibit 18, Belgian American Exhibit 18. Then the directors' meeting, there was a vote to sell certain securities held by the company and to purchase a certificate of deposit from Belgian American Bank, and the next item was voting the Belgian American Bank authorization form.

* * * * *

[77] Q. Shall we take them up one by one? What was the first vote? A. The first vote was to sell enough securities to purchase a certificate of deposit from the Belgian American Bank in the amount of $5 million.

Q. That resolution was passed? A. Yes.

Q. What securities were to be sold? A. I believe they were mostly Government bonds and I believe there were some other corporate bonds. I am not sure.

* * * * *

[287] Q. Just tell us what happened. A. I said that we would need a vote to sell securities held by Manhattan and to use the proceeds to purchase a certificate of deposit from the Belgian American Bank in the amount of $5 million. I believe the interest rate was stated but I don't recall whether I stated it or Mr. Begole stated what the interest rate was. That was noted.

* * * * *

Alexander Kosloff, Deposition

* * * * *

[134] Q. That's all right. You can just go right ahead and do it, if you like.

What happened then?

Let me ask you, was a proposal made in that directors' meeting to sell the company's Government portfolio in its entirety, except for those bonds which were on deposit with regulatory authorities? A. There was a proposal to sell the portfolio of U. S. Government bonds held in the custody of the Chemical Bank, New York Trust Company.

Q. Who made that proposal? A. I believe it was Mr. Begole. Again, I am not positive, but I think it was Mr. Begole.

* * * * *

[135] Q. And so is it fair to say that it was a matter of deep interest to you as a director and member of the investment committee, this proposal to sell the entire portfolio of Manhattan's Government bonds? A. Sir, the question of the depth of interest is something that you are proposing. I would say, of course, the matters dealing with Manhattan Casualty Company, all of them, were matters of interest to me.

Q. Well, what was said about this proposal that you think was made by Mr. Begole in the directors' meeting to sell the entire portfolio of Government bonds belonging to Manhattan? A. Again, it is very difficult to remember all of it, [136] but there was some discussion by Mr. Begole with respect to the projection of the bond market in general.

Q. What did he say? A. Well, it was a rather pessimistic view.

Q. What did he say? A. I can't recall the language he used.

Q. To the best of your recollection, in general terms, not his exact words, what was the substance? A. Generally, the substance being that the bond market for U. S. Government bonds didn't look too good in the future, and that the purchase of a certificate of deposit would provide a guaranteed income, and a measure of safety. There was general language to that effect.

• • • • •

Sweeny, Deposition

* * * * *

[161] A. No. The meeting continued and the first order of business, Adams put forth a resolution to the board to sell the company's government portfolio in its entirety except for those bonds which were on deposit with regulatory authorities, and out of the proceeds of that sale to purchase a five million dollar certificate of deposit from the Belgian American Bank.

Q. Was this motion carried? A. It was carried. I don't know who seconded the motion, but I know it was carried.

* * * * *

[596] Q. Did you know that before? A. I was under the impression originally that the five million dollars would already be in Belgian American Bank, because of the resolution of sale at the board meeting.

Q. The resolution of sale of what? A. Of the securities.

Q. In other words, you were under the impression that the securities would be sold and the proceeds immediately deposited to Belgian American Bank. A. Yes, because the certificate of deposit, which was also authorized at the board meeting, it was specifically stated that it would be issued by Belgian American Bank.

Q. Where did you get the information that Belgian American Bank was to issue a certificate of deposit, Mr. Sweeny? A. From Mr. Adams. He put it in a resolution form.

* * * * *

Exhibit—Excerpts From Minutes of a Special Meeting of the Board of Directors of Manhattan Casualty Company

A Special Meeting of the Board of Directors of MANHATTAN CASUALTY COMPANY was held at the offices of the Company, 116 John Street, Borough of Manhattan, City of New York, at 12:30 o'clock in the afternoon on the 24th day of January, 1962.

PRESENT:

SAMUEL ADAMS
JAMES F. BEGOLE
EDGAR BLOCH
CHARLES I. HOGAN
MILTON KATZ
ALEXANDER KOSLOFF
JACOB J. MILMAN
F. PAUL MORGAN
S. PEYTON STALLWORTH
JOHN F. SWEENY
RALPH A. TANGUAY
GUY E. WYATT

The meeting was called to order and presided over by Mr. James F. Begole.

Mr. Alexander Kosloff acted as Secretary of the meeting.

The Secretary announced that Notice of the Special Meeting had been given to the Directors in person and that twelve (12) of the thirteen (13) Directors were present and constituted a quorum.

* * * * *

The Chairman then submitted to the Board the matter of effecting a change in its portfolio of securities.

Exhibit—Excerpts From Minutes of a Special Meeting of the Board of Directors of Manhattan Casualty Company

After discussion, and on motion duly made, seconded and carried, it was

RESOLVED, that the President be and he hereby is authorized to sell the entire portfolio of UNITED STATES GOVERNMENT BONDS and NOTES held in custody by the CHEMICAL BANK NEW YORK TRUST COMPANY, at 100 Broadway, New York, N.Y.; and be it

FURTHER RESOLVED, that the President be and he hereby is authorized to purchase a CERTIFICATE OF DEPOSIT from the BELGIAN-AMERICAN BANK AND TRUST COMPANY, not exceeding a face value of FIVE MILLION and 00/100 ($5,000,000.00) DOLLARS, for a term of six (6) months, with interest at 3% per annum, which Certificate of Deposit is to be held in trust for the account of the Company upon receipt of a letter from the Belgian-American Bank and Trust Company certifying to the above.

* * * * *

Complaint Filed in State Court Action

SUPREME COURT
OF THE STATE OF NEW YORK

COUNTY OF NEW YORK

[SAME TITLE]

Plaintiff, by his attorney, Arnold Bauman, as and for his complaint herein respectfully alleges:

1. Plaintiff is the Superintendent of Insurance of the State of New York. On May 24, 1963, by order of the Supreme Court of the State of New York, Plaintiff, as said Superintendent of Insurance, was appointed Liquidator of Manhattan Casualty Company. As Liquidator, he is vested with title to all property, contracts and rights of action of Manhattan Casualty Company.

2. Defendant, Bankers Life & Casualty Company (hereinafter referred to as "Bankers Life") is a corporation organized and existing under the laws of the State of Illinois.

3. Defendant Irving Trust Company (hereinafter referred to as "Irving Trust"), is a corporation organized and existing under the laws of the State of New York, with its principal place of business at 1 Wall Street, City and State of New York.

4. Defendant, Belgian American Banking Corporation (hereinafter referred to as "BA Banking"), is a corporation organized and existing under the laws of the State

of New York, with its principal place of business at 52 Wall Street, City and State of New York.

5. Defendant, Belgian American Bank and Trust Company (hereinafter referred to as "BA Trust") is a corporation organized and existing under the laws of the State of New York, with its principal place of business at 52 Wall Street, City and State of New York.

6. Defendant, Garvin, Bantel & Company (hereinafter referred to as "Garvin, Bantel"), is a partnership engaged in the transaction of business within the State of New York, with its principal place of business at 120 Broadway, City and State of New York.

7. Defendant, New England Note Corporation (hereinafter referred to as "New England Note") formerly New England Acceptance Co., Inc., is a corporation organized and existing under the laws of the State of Massachusetts.

8. Defendant, George K. Garvin (hereinafter referred to as "Garvin"), is a citizen of the State of New York, residing at 30 East 65th Street, New York, New York, and was at all times hereinafter referred to, a partner in Garvin, Bantel.

9. Defendant, James F. Begole (hereinafter referred to as "Begole"), is a citizen of the State of New York, residing at 1169 Hardscrabble Road, Chappaqua, New York.

10. Defendant, John F. Sweeny (hereinafter referred to as "Sweeny"), is a resident and citizen of the State of New Jersey.

State Court Complaint

11. Defendant, Standish T. Bourne (hereinafter referred to as "Bourne"), is a resident and citizen of the State of Massachusetts.

As and for a First Claim for Relief Plaintiff Alleges Upon Information and Belief:

12. Manhattan Casualty Company (hereinafter referred to as "Manhattan") was incorporated under the laws of the State of New York, on January 13, 1949, and commenced business on June 1, 1949. It was authorized as of May 23, 1963, to transact the following kinds of insurance business as defined in Section 46 of the Insurance Law of the State of New York; accident and health, fire, miscellaneous property, water damage, burglary and theft, glass, elevator, collision, personal injury liability, property damage liability, workmen's compensation and employers' liability, fidelity and surety, motor vehicle and aircraft and marine insurance (excluding ocean marine insurance and insurance against loss or damage by reason of injury to the person). In addition, Manhattan was authorized by the United States Department of Labor to write compensation insurance provided under the Federal Longshoremen's and Harbor Workers' Compensation Act.

13. As of December 31, 1962, Manhattan was authorized to transact business in the States of Connecticut, Delaware, Florida, Maine, Maryland, Massachusetts, New Hampshire, New York, Rhode Island, Vermont, Virginia, West Virginia and the District of Columbia.

14. During all the times hereinafter referred to, Manhattan had its principal office at No. 116 John Street, City and State of New York.

15. On May 24, 1963, the corporate charter of Manhattan was forfeited, surrendered and annulled and Manhattan was dissolved by order of the Supreme Court of the State of New York, held in and for the County of New York (Honorable Peter A. Quinn, Justice).

16. In November, 1961, Bankers Life was the owner of all the outstanding shares of Manhattan. The shares so outstanding consisted of 100,000 shares of prior preferred stock, 10,000 shares of preferred stock and 180,000 shares of common stock.

17. Commencing in or about November, 1961, in connection with and in furtherance of a sale of said shares, the defendants and/or their officers, agents and representatives unlawfully and with a fraudulent intent conspired and connived to defraud Manhattan, its creditors and policyholders and to that end employed a device, scheme and artifice by which they were able to despoil Manhattan of its assets and dispose of the same to their individual benefit and profit.

18. In pursuance of said scheme to defraud, Bourne and Begole between November, 1961, and January 19, 1962, negotiated for the purchase of said outstanding shares of Manhattan with Sweeny, James W. Bourland (hereinafter referred to as "Bourland"), Vice-President of Bankers Life, and others.

19. On January 19, 1962, a contract of sale for the said shares was entered into between Begole, as purchaser, and Bankers Life, as seller, of the shares of Manhattan. It provided that the price to be paid Bankers Life was $5,000,000, by bank or certified check, which was to be delivered at the

closing on January 24, 1962. The contract was executed for Bankers Life by Bourland, as Vice-President; for Manhattan by Bourland, as Executive Vice-President, and by Begole.

20. Between January 19, 1962, and January 24, 1962, Bourne informed Begole that he would provide Begole with the funds necessary to purchase Manhattan.

21. At the request of Bourne and in furtherance of said scheme, Garvin arranged with BA Trust to issue a certificate of deposit for $5,000,000 in the name of Manhattan, and arranged with BA Banking to lend $5,000,000 to New England Note upon the security of the certificate of deposit to be issued in the name of Manhattan.

22. On January 23, 1962, Garvin, in furtherance of said scheme, asked C. Joseph Gunter (hereinafter referred to as "Gunter"), Assistant Secretary of Irving Trust, to appear at his office the next morning with a check of Irving Trust for $5,000,000 payable to Bankers Life and told Gunter that Irving Trust would receive securities on January 24, 1962, to provide the funds for this check.

23. On January 24, 1962, Begole, in the presence of Bourne, Sweeny, Gunter and Garvin, executed two notes totalling $5,250,000, payable to New England Note. One note was in the sum of $5,000,000 and bore interest at the rate of 7½%; the second note was in the amount of $250,000 and bore interest at the rate of 5%. Begole also executed an assignment of the shares of Manhattan to New England Note.

24. On the morning of January 24, 1962, in the presence of Begole, Sweeny and Garvin, at the office of Manhattan,

Gunter delivered the Irving Trust check for $5,000,000, payable to Bankers Life, to Leo Lehane, Executive Vice-President of Bankers Life.

25. Immediately thereafter, in furtherance of said scheme to defraud, Begole called a stockholders meeting, at which Begole and Sweeny were elected Directors of Manhattan. A Board of Directors meeting was then called for the election of officers for Manhattan. Begole was elected Chairman of the Board and Sweeny was elected President. The Board of Directors then adopted a resolution authorizing the sale of $5,155,000 in United States Government securities, the property of Manhattan and the purchase of a 3% Certificate of Deposit in the amount of $5,000,000 from BA Trust.

26. Shortly thereafter, on January 24, 1962, the aforementioned United States Government securities, the property of Manhattan, were transferred through Garvin Bantel to Irving Trust. They were sold later that day to Second District Securities Company for the account of Manhattan by Garvin, Bantel and delivered by Irving Trust to the purchaser. The proceeds of $4,854,552.67 together with other transfers of cash in the amount of $150,000 were credited to an account in the name of Manhattan at Irving Trust, who charged the $5,000,000 payment to Bankers Life against these funds.

27. Later that day, at the request of Garvin Bantel, Gunter brought to the offices of BA Trust another check of Irving Trust in the amount of $5,000,000, payable to the order of BA Trust. There, he delivered it to Sweeny who turned it over to Paul Sandrisser, Vice-President of

BA Trust who thereupon issued a certificate of deposit, in the name of Manhattan for $5,000,000 payable in six months, accepting the Irving Trust check in payment. Sweeny, as President and Milton Katz, as Assistant Treasurer of Manhattan, at the insistence of Sandrisser, endorsed the certificate of deposit to New England Note. Bourne, as President of New England Note, endorsed the certificate of deposit over to BA Banking as collateral security on a six month loan of $5,000,000 made by BA Banking to New England Note. A check of BA Banking in the sum of $5,000,000 representing the proceeds of this loan was then turned over to Gunter, in repayment of the $5,000,000 Irving Trust check given to BA Trust to purchase the certificate of deposit. At the same time BA Banking made another loan to New England Note in the sum of $250,000, which was secured by the aforementioned outstanding shares of Manhattan. This sum was deposited by New England Note in BA Trust and was disbursed, in part, as follows: Garvin, Bantel—$25,000; Begole—$50,000; Bourne—$50,000; BA Banking—$100,000.

28. Between January 24 and January 29, 1962, a series of entries were made on the books of Irving Trust for the purpose of concealing the transactions alleged in paragraphs 22, 23, 24, 26 and 27.

29. On or about January 29, 1962, for the purpose of concealing the transactions referred to in paragraphs 22, 23, 24, 26 and 27, Garvin, at the request of Irving Trust, obtained backdated letters signed by Bourne.

30. For the purpose of concealing the above transactions Sweeny, as President of Manhattan certified to the New

York State Insurance Department in Manhattan's quarterly financial statements, for the period ending March 31, 1962, and June 30, 1962, that Manhattan had on deposit at BA Trust, the sum of $5,000,000. These financial statements failed to reveal that the said $5,000,000 deposit at BA Trust was in any way encumbered or impaired.

31. On July 24, 1962, the aforementioned certificate of deposit, the loans made by BA Banking to New England Note, and the loans made by New England Note to Begole, matured. As part of the scheme to defraud and in furtherance thereof, BA Trust issued a new certificate of deposit in the amount of $5,000,000 in the name of Manhattan payable on January 24, 1963. This was endorsed by Sweeny, as Treasurer, and Begole, as Chairman, of Manhattan. The Begole and New England Note loans were extended to January 24, 1963. On July 24, 1962, Begole, advised BA Trust that the new $5,000,000 certificate of deposit and all of Manhattan's outstanding shares, collateralized the extended $5,000,000 loan to New England Note.

32. To further conceal the aforementioned transactions, Sweeny as President of Manhattan certified to the New York State Insurance Department in Manhattan's quarterly financial statement for the period ending September 30, 1962, and in Manhattan's annual financial statement for 1962, that Manhattan had on deposit at BA Trust, the sum of $5,000,000. These financial statements failed to reveal that the said $5,000,000 deposit at BA Trust was in any way encumbered or impaired.

33. As a result of all of the aforementioned acts of concealment, Manhattan, its creditors, policyholders and the New York State Insurance Department were misled in that

in fact this asset of Manhattan's the $5,000,000 certificate of deposit issued by BA Trust was encumbered.

34. On January 21, 1963, Begole at the request of Bourne and Garvin, instructed Irving Trust to issue $5,500,000 in bearer certificates of deposit for the account of Manhattan and directed that they be delivered against payment to Garvin Bantel. On January 22, 1963, Marine Midland Trust Company of New York (hereinafter referred to as "Marine Midland") loaned Garvin Bantel $5,500,000 on the security of the aforementioned bearer certificates of deposit and the proceeds of this loan were delivered to Irving Trust in payment for the said bearer certificates of deposit.

35. On January 23, 1963, in furtherance of the aforesaid scheme to defraud, Sweeny, Begole, Garvin and Sandrisser agreed that the proceeds of Manhattan's $5,500,000 certificates of deposit at BA Trust would be used to liquidate the New England Note loan at BA Banking.

36. On January 25, 1963, BA Trust credited Manhattan with $5,075,616.44, the proceeds of the BA Trust certificate of deposit payable to Manhattan, as well as $515,361.18 the proceeds of the certificate of deposit issued by the First National Bank of Boston payable to Manhattan. At the direction of Sweeny, B. A. Trust issued its check to Irving Trust in the sum of $5,500,000 and charged Manhattan's account. Irving Trust, at the direction of Garvin Bantel credited this check to the account of Garvin Bantel. Against this credit of the $5,500,000 check and at the direction of Garvin Bantel, Irving Trust debited Garvin Bantel's account for a check in the sum of $5,250,000. This check was issued to B. A. Banking which applied it in payment of the outstanding New England Note loans.

37. On April 18, 1963, B. A. Banking delivered to Begole and Sweeny the shares of stock of Manhattan registered in the name of Begole.

38. In furtherance of the aforesaid scheme to defraud, on May 15, 1963, Irving Trust certified to the New York State Insurance Department that Manhattan had on deposit at Irving Trust the sum of $5,500,000 evidenced by the certificates of deposit described in paragraph 34 hereof and further certified the said certificates were free of all liens, claims, or encumbrances, and were not held as security for any loans.

39. On or about August 22, 1963, Marine Midland applied the proceeds of the certificates of deposit described in paragraph 34 hereof, to the satisfaction of the loan from Marine Midland to Garvin Bantel.

40. By reason of the foregoing acts, the defendants herein did unlawfully conspire and in furtherance thereof did employ a device scheme and artifice whereby the assets of Manhattan have been depleted and plaintiff, as Liquidator of Manhattan, and the creditors and policyholders of Manhattan have been damaged to the extent of $5,500,000.

As and for a Second Cause of Action Against the Defendant Irving Trust Company, Plaintiff Alleges on Information and Belief:

41. Plaintiff repeats and realleges each and every allegation contained in paragraphs 1 through 26.

42. Manhattan instructed Irving Trust on January 24, 1962, to receive the aforementioned United States Govern-

ment securities, the property of Manhattan, to deliver them against the proceeds of the sale and to credit the proceeds of the sale, together with Manhattan's aforementioned transfers of cash in the amount of $150,000, to Manhattan's account at Irving Trust.

43. On January 24, 1962, Irving Trust credited the proceeds of the sale of Manhattan's United States Government securities and Manhattan's transfers of cash to an account in that bank, in the name of Manhattan.

44. Irving Trust, by debiting the check for $5,000,000 it had issued to Bankers Life to this account of Manhattan's against the proceeds of Manhattan's United States Government securities and the transfers of cash, did so without authority and without instructions from Manhattan.

45. Plaintiff has made due demand of Irving Trust for the surrender and delivery to Plaintiff of the aforesaid assets of Manhattan, but Irving Trust refused and still refuses to do so, and has unlawfully converted and disposed of the aforesaid assets of Manhattan, to its own use and benefit all to the damage of plaintiff as Liquidator of Manhattan, and the creditors and policyholders of Manhattan, in the sum of $5,000,000.

As and for a Third Cause of Action Against the Defendant Irving Trust Company, Plaintiff Alleges on Information and Belief:

46. Plaintiff repeats and realleges each and every allegation contained in paragraphs 1 through 26.

47. On January 24, 1962, Manhattan opened a bank account with and became a depositor of Irving Trust, under

the customary and ordinary rules and regulations applicable to banking institutions.

48. Irving Trust promised and agreed, among other things, to hold moneys deposited to Manhattan's account and to repay said moneys upon proper order of Manhattan.

49. On January 24, 1962, Gunter at the direction of Garvin, had an Irving Trust check issued, to the order of Bankers Life, for $5,000,000. Gunter then, at a closing held at the offices of Manhattan, delivered this check to officers of Bankers Life. Gunter knew that this check represented the purchase price being paid to Bankers Life, on its sale of 100% of the outstanding stock of Manhattan to Begole.

50. Manhattan instructed Irving Trust on January 24, 1962, to receive the aforementioned United States Government securities, the property of Manhattan, to deliver them against the proceeds of the sale, and to credit the proceeds of the sale, together with Manhattan's aforementioned transfers of cash to an account in that bank, in the name of Manhattan.

51. On January 24, 1962, Irving Trust credited the proceeds of the sale of Manhattan's United States Government securities and Manhattan's transfers of cash to an account in that bank, in the name of Manhattan.

52. Later that day, at the direction of Garvin, Irving Trust debited the $5,000,000 check to Bankers Life to this account of Manhattan's against the proceeds of Manhattan's United States Government securities and the aforementioned transfers of cash.

53. Irving Trust, by debiting the check for $5,000,000 it had issued to Bankers Life to this account of Manhattan's, did so knowing that Garvin was neither an officer, director, employee or agent of Manhattan and that this check to Bankers Life was for a non-corporate purpose of Manhattan. These facts put Irving Trust on inquiry, which it failed to make of Manhattan, which would have disclosed that Garvin was not authorized to act on behalf of Manhattan and that the debit to Manhattan's account of the $5,000,000 check to Bankers Life, was not authorized by Manhattan.

54. The Irving Trust check for $5,000,000 payable to Bankers Life, was so debited to Manhattan's account at Irving Trust, solely because of the negligence of Irving Trust and without any negligence on the part of Manhattan contributing thereto.

55. Plaintiff has made due demand of Irving Trust for the payment of the said sum of $5,000,000 but Irving Trust refused and still refuses to do so, and there is now due and owing to Plaintiff as Liquidator of Manhattan from Irving Trust the said sum of $5,000,000.

As and for a Fourth Cause of Action Against the Defendants, Belgium American Bank & Trust Co., Belgian American Banking Corp., and Irving Trust Company, Plaintiff Alleges on Information and Belief:

56. Plaintiff repeats and realleges each and every allegation contained in paragraphs 1 through 39.

57. The $5,000,000 certificate of deposit issued by BA Trust to the order of Manhattan on July 24, 1962, was

the property of Manhattan and represented an asset of Manhattan on deposit at BA Trust.

58. On August 30, 1962, a $500,000 certificate of deposit issued by The First National Bank of Boston to Manhattan representing an asset of Manhattan on deposit at The First National Bank of Boston, was delivered to BA Trust.

59. In or about January 1963, Sweeny, Begole, Garvin Bantel, Garvin, BA Trust, BA Banking and Irving Trust conspired and connived to convert the assets of Manhattan to their own use and benefit.

60. On January 23, 1963, Sweeny, Begole, Garvin and Sandrisser agreed that the proceeds of Manhattan's two certificates of deposit in the amount of $5,500,000 on deposit at BA Trust would be used to liquidate the $5,250,000 loan made by BA Banking to New England Note.

61. In furtherance of said scheme, on January 25, 1963, BA Trust credited Manhattan with $5,075,616.44, the proceeds of the BA Trust certificate of deposit payable to Manhattan, as well as $515,361.18, the proceeds of the certificate of deposit issued by the First National Bank of Boston, payable to Manhattan. At the direction of Sweeny, BA Trust issued its check payable to Irving Trust in the sum of $5,500,000 and charged Manhattan's account. Irving Trust, as part of the aforesaid scheme and at the direction of Garvin Bantel, credited this check for $5,500,000 to the account of Garvin Bantel. Against this credit of $5,500,000 to the account of Garvin Bantel, and at the direction of Garvin Bantel, Irving Trust issued its check payable to

BA Banking in the amount of $5,250,000 and debited Garvin Bantel's account. This check for $5,250,000 was delivered to BA Banking which applied it in full payment of the outstanding loans of New England Note to BA Banking.

62. The defendants, BA Trust, BA Banking and Irving Trust, in applying the proceeds of these two certificates of deposit of Manhattan in payment of New England Note's loans of $5,250,000 to BA Banking, did so without authority or instruction from Manhattan.

63. Plaintiff has made due demand of BA Trust, BA Banking and Irving Trust for the surrender and delivery to plaintiff of the aforesaid assets of Manhattan, but these defendants have refused and still refuse to do so and have unlawfully converted and disposed of the aforesaid assets of Manhattan, to their own use and benefit, all to the damage of plaintiff, as Liquidator of Manhattan, and the creditors and policyholders of Manhattan, in the sum of $5,500,000.

As and for a Fifth Cause of Action Against the Defendants, Belgian American Bank & Trust Co. and Belgian American Banking Corp., Plaintiff Alleges on Information and Belief:

64. Plaintiff repeats and realleges each and every allegation contained in paragraphs 1 through 39.

65. On July 24, 1962, Manhattan opened a bank account with and became a depositor of BA Trust, under the customary and ordinary rules and regulations applicable to banking institutions.

66. BA Trust promised and agreed, among other things to hold moneys deposited to Manhattan's account and to repay said moneys upon proper order of Manhattan.

67. On July 24, 1962, BA Trust issued to the order of Manhattan a $5,000,000 certificate of deposit, which certificate represented an asset of Manhattan on deposit at BA Trust.

68. On July 24, 1962, BA Banking renewed two loans in the amount of $5,250,000 it had previously granted to New England Note. These loans were due and payable on January 24, 1963.

69. On August 30, 1962, a $500,000 certificate of deposit issued by the First National Bank of Boston to Manhattan, representing an asset of Manhattan on deposit at the First National Bank of Boston, was delivered to BA Trust for safekeeping.

70. On January 23, 1963, Sweeney, Begole, Garvin and Sandrisser agreed that the proceeds of Manhattan's two certificates of deposit in the amount of $5,500,000 on deposit at BA Trust would be used to liquidate the New England Note loans at BA Banking.

71. On January 25, 1963, BA Trust credited Manhattan with $5,075,616.44, the proceeds of the BA Trust certificate of deposit payable to Manhattan, as well as $515,361.18 the proceeds of the certificate of deposit issued by the First National Bank of Boston payable to Manhattan. At the direction of Sweeny, BA Trust issued its check payable to Irving Trust in the sum of $5,500,000 and charged Manhattan's account. Irving Trust, at the direction of Garvin

Bantel, credited this check for $5,500,000 to the account of Garvin Bantel. Against this credit of $5,500,000 to the account of Garvin Bantel and at the direction of Garvin Bantel, Irving Trust issued its check payable to BA Banking in the amount of $5,250,000 and debited Garvin Bantel's account. This check for $5,250,000 was delivered to BA Banking which applied it in full payment of the outstanding loans of New England Note to BA Banking.

72. The defendants BA Trust and BA Banking in applying the proceeds of these two certificates of deposit of Manhattan in payment of New England Note's loans in the amount of $5,250,000 did so with the knowledge that the payment of the New England Note's loans by Manhattan was a non-corporate purpose and was a possible misappropriation of Manhattan's assets by officers of Manhattan. These facts put BA Trust and BA Banking on inquiry, which they failed to make of Manhattan, which would have disclosed that the payment of the two loans of New England Note in the amount of $5,250,000 was not authorized.

73. The New England Note loans at BA Banking were paid for out of the assets of Manhattan, solely because of the negligence of BA Trust and BA Banking and without any negligence on the part of Manhattan contributing thereto.

74. Plaintiff has made due demand of BA Trust and BA Banking for the payment of the said sum of $5,500,000 but BA Trust and BA Banking refused and still refuse to do so, and there is now due and owing to plaintiff as Liquidator of Manhattan from BA Trust and BA Banking the said sum of $5,500,000.

WHEREFORE, Plaintiff demands judgment:

(a) On its First Cause of Action, against Bankers Life & Casualty Company, Irving Trust Company, Belgian American Banking Corporation, Belgian American Bank & Trust Company, Garvin Bantel & Company, New England Note Corporation, George K. Garvin, James F. Begole, John F. Sweeny, and Standish T. Bourne, jointly and severally, for $5,500,000 with interest from the 24th day of January, 1962.

(b) On its Second Cause of Action, against Irving Trust Company for $5,000,000 with interest from the 24th day of January, 1962.

(c) On its Third Cause of Action, against Irving Trust Company for $5,000,000 with interest from the 24th day of January, 1962.

(d) On its Fourth Cause of Action, against Belgian American Bank & Trust Company, Belgian American Banking Corporation and Irving Trust Company, jointly and severally for $5,500,000 with interest from the 25th day of January, 1963.

(e) On its Fifth Cause of Action, against Belgian American Bank & Trust Company and Belgian American Banking Corporation, jointly and severally, for $5,500,000 with interest from the 25th day of January, 1963;

Together with the costs and disbursements of this action, and for such other, further or different relief as to the Court may seem just and proper.

ARNOLD BAUMAN,
Attorney for Plaintiff,
Office & Post Office Address,
No. 30 Rockefeller Plaza,
New York, New York 10020.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1970

No. ~~1159~~ 70-60

Superintendent of Insurance of the State of New York, as Liquidator of MANHATTAN CASUALTY COMPANY,

Petitioner,

—against—

BANKERS LIFE AND CASUALTY COMPANY,
IRVING TRUST COMPANY,
BELGIAN AMERICAN BANKING CORPORATION,
BELGIAN AMERICAN BANK & TRUST COMPANY,
GARVIN, BANTEL & COMPANY,
GEORGE K. GARVIN,

Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1970

No. .....

Superintendent of Insurance of the State of New York,
as Liquidator of MANHATTAN CASUALTY COMPANY,

Petitioner,

—against—

BANKERS LIFE AND CASUALTY COMPANY,
IRVING TRUST COMPANY,
BELGIAN AMERICAN BANKING CORPORATION,
BELGIAN AMERICAN BANK & TRUST COMPANY,
GARVIN, BANTEL & COMPANY,
GEORGE K. GARVIN,

Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioner the Superintendent of Insurance of the State of New York, as Liquidator of Manhattan Casualty Company prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit entered in this case on July 22, 1970. Petitioner's motion for rehearing and rehearing en banc was denied by orders dated September 30, 1970.

Opinions Below

The opinion of the Court of Appeals for the Second Circuit, 430 F.2d 355 (1970) is annexed and appears at pages 1a-14a of Appendix A.* The opinions of the District Court for the Southern District of New York, 300 F. Supp. 1083 (S.D.N.Y. 1969) are annexed and appear at App. D, p. 17a and App. E, p. 57a.

Jurisdiction

The judgment of the Court of Appeals sought to be reviewed was entered on July 22, 1970. The petition for rehearing and rehearing en banc was denied by orders dated September 30, 1970, App. B, p. 15a; App. C, p. 16a. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

Questions Presented

1. Did the Court below err in affirming the dismissal of the complaint where the record disclosed that a board of directors was fraudulently induced to authorize the sale of securities owned by a corporation and the proceeds of such sale were wrongfully diverted from the corporation?

2. Are Rule 10b-5 and Section 10(b) violated where full value is paid by a purchaser of securities and the proceeds are immediately misappropriated by corporate seller's management and others as part of a fraudulent scheme to loot the corporation of its assets?

3. Does the decision appealed from conflict with the decision of the Court of Appeals for the Fifth Circuit in

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* Citations to appendix hereinafter will appear, "App. A., p. ——", "App. B., p. ——."

Hooper v. *Mountain States Securities Corp.*, 282 F.2d 195 (1960)?

4. Should the strict purchaser-seller limitations enunciated in *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952) cert. denied, 343 U.S. 956 (1952) be abolished?

5. Has the Court of Appeals, in holding that Petitioner has not alleged a federal cause of action in connection with the transactions involving certificates of deposit, ruled erroneously on an important question of securities law that has not been but should be decided by the Supreme Court?

Statutes and Regulations Involved

This is an action for damages based on violations of section 17(a) of the Securities Act of 1933, hereinafter the Securities Act, 15 U.S.C. section 77q(a), 3 United States Code at 2658 (1964 edition), and section 10(b) of the Securities Exchange Act of 1934, hereinafter the Exchange Act, 15 U.S.C. section 78j(b), 3 United States Code at 2698 (1964 edition), together with Rule 10b-5, 17 CFR section 240.10(b)(5) at 296 (revised as of Jan. 1, 1970), promulgated thereunder.

Section 17(a) of the Securities Act states:

> "It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission

to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

Section 10(b) of the Exchange Act states:

"Section 10 It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Rule 10b-5 provides:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security."

Statement of the Case

A. Basis for Federal Jurisdiction

Federal jurisdiction in the court of first instance is based on sections 77v, 78aa of Title 15, United States Code. Section 77v in part states:

"(a) The district courts of the United States, . . ., shall have jurisdiction of offenses and violations under this subchapter and under the rules and regulations promulgated by the Commission in respect thereto, and, concurrent with State and Territorial courts, of all suits in equity and actions at law brought to enforce any liability or duty created by this subchapter."

Section 78aa states in part:

"The district courts of the United States, . . ., shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder."

B. Procedural History

In May, 1963, the Superintendent of Insurance of the State of New York (Petitioner) was appointed Liquidator of Manhattan Casualty Company (Manhattan) by order of the New York State Supreme Court (Sup. Ct., N.Y.

Co., Index No. 40931/1963). That order vested Petitioner with all the rights of action of Manhattan. In that capacity, Petitioner commenced this action in August, 1963. The Petitioner was not a party to the transactions complained of, nor did he possess first hand knowledge of the events in question. The complaint was drawn on the basis of facts disclosed at hearings held by the Insurance Department of the State of New York in connection with proceedings which led to the liquidation of Manhattan.

After six and one half years of extensive discovery, yielding approximately 12,000 pages of testimony and 500 documents marked for identification, additional facts foreshadowed by the allegations in the complaint have come to light and are included in the record.

The Note of Issue was filed on August 31, 1967. On April 17, 1968, defendant Bankers Life and Casualty Company (Bankers Life) moved in the United States District Court for the Southern District of New York for summary judgment. Judge Sylvester J. Ryan denied that motion without prejudice, and suggested that the questions of subject matter jurisdiction and Petitioner's standing to sue be reached *in limine*.

Accordingly, Bankers Life, defendant Belgian American Banking Corporation (Belgian Banking) and Belgian American Bank and Trust Company (Belgian Trust) moved to dismiss this action pursuant to Rules 12(c) and 12(h) of the Federal Rules of Civil Procedure before the late Judge William B. Herlands. Defendants Irving Trust Company (Irving Trust), Garvin Bantel & Company (Garvin, Bantel) and George K. Garvin (Garvin) made identical motions before Judge Ryan. Both motions were granted by judgments entered on June 4, 1969 and June 17, 1969, respectively.

Petitioner appealed and on July 22, 1970, the United States Court of Appeals for the Second Circuit affirmed the judgments of the District Court. Judge Hays dissented. Although the majority opinion found as did Judge Herlands, that a fraud had been committed, the Court held that Petitioner had failed to allege a claim for relief under the federal securities acts. It is from this judgment that Petitioner seeks certiorari.

C. The Facts

1. *Sale of Manhattan Stock.*

Manhattan was the victim of a fraudulent scheme whereby it was purchased with and looted of its assets. Until January 24, 1962, Bankers Life was the sole stockholder of Manhattan. The fraudulent scheme is reflected in the following events. On that day, Bankers Life sold its stock in Manhattan for $5,000,000 to a purchasing group which included Standish T. Bourne (Bourne) and James F. Begole (Begole). Bourne and Begole arranged in advance with Irving Trust that it would issue its check for $5,000,000 in payment of the purchase price to Bankers Life. On January 24, 1962, Irving Trust sent an officer with a check for $5,000,000 to attend the closing of the sale of the stock. At that closing he delivered the check made payable to Bankers Life as the purchase price for Manhattan stock. At this point in time, Manhattan did not maintain an account at Irving Trust. Shortly after the closing, the entire Manhattan portfolio of government securities totaling almost $5,000,000 was sold to Second District Securities which delivered a check in the amount of $4,854,552.67 representing the proceeds of the sale to Irving Trust. Manhattan transferred cash to Irving to bring the total to $5,000,000. Irving Trust promptly applied the proceeds against the $5,000,000 check it had delivered to Bankers

Life earlier that morning. These transactions, as well as those of the afternoon of January 24, 1962, were conceived by Garvin, a general partner in the note brokerage firm of Garvin, Bantel.

The perpetrators deceived Manhattan's board of directors into voting approval for the sale of Manhattan's portfolio of United States Government Bonds by representing that the proceeds would be used to purchase a certificate of deposit (CD).* In short, Manhattan sold assets worth almost $5,000,000 as a result of the deception of its board of directors and received nothing in return.

In order to conceal the depletion of $5,000,000 of assets and Manhattan's resultant insolvency, a paper asset had to be created. As part of the scheme, Garvin and Garvin, Bantel had arranged in advance for a check swap to take place among three financial institutions on that very afternoon. Irving Trust issued a $5,000,000 check in the name of Manhattan which was tendered to Belgian Trust. Belgian Trust then issued a $5,000,000 CD in the name of Manhattan. John F. Sweeny (Sweeny), newly installed as President of Manhattan after its sale that morning, endorsed the CD over to New England Note Corporation (New England Note), a company controlled by Bourne. Bourne then endorsed the CD over to Belgian Banking, which used the CD as collateral for a so-called $5,000,000 loan to New England Note. A Belgian Banking check for $5,000,000 representing the New England Note loan was immediately given to Irving Trust to repay it for its check to Belgian Trust. Thus an asset in identical amount to that of which Manhattan was defrauded was created in its name and

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* See pages 97a-101a of the Appendix to Petitioner's main brief in the United States Court of Appeals. Said Appendix was certified and transmitted to the Supreme Court by the Clerk of the Court of Appeals for the Second Circuit.

carried on its books as cash without reference to its total hypothecation, for the sole purpose of concealment.

Belgian Banking made a second loan to New England Note in the amount of $250,000 which was distributed in part as follows: Belgian Banking $100,000, Bourne $50,000, Begole $50,000, and Garvin, Bantel $25,000.

At the close of January 24, 1962, ownership of the shares of Manhattan had been transferred. Irving Trust had issued two $5,000,000 checks. It was reimbursed in full for the first from the assets of Manhattan. It was reimbursed in full for the second by the check of Belgian Banking representing the proceeds from the so-called loan to New England Note for which a CD in the name of Manhattan served as collateral.

During this period, Manhattan had no account at Irving Trust. In order to conceal the transactions, Irving made a series of false entries on its books. These entries were supported by backdated letters obtained for Irving by Garvin from Bourne. The acts described above were all part of one fraudulent scheme designed to gain control of Manhattan by using its assets to meet the purchase price.

2. *Events subsequent to January 24, 1962.*

On July 24, 1962, the CD and the alleged loans made by Belgian Banking and Belgian Trust to New England Note matured. To continue to conceal the depletion of Manhattan's assets, Bourne, Garvin and Garvin, Bantel, Begole, Belgian Banking and Belgian Trust arranged to renew the loans and to issue a new CD to be held as collateral in the manner of January 24, 1962. However, at this point Sweeny, the President of Manhattan and a member of its board, now fearful, objected to the fact that the certificate was to be hypothecated. The other named defendants therefore mis-

represented to him and consequently to Manhattan whose agent he was, that the certificate to be issued would not be held as collateral and that the stock of Manhattan would be the sole collateral for the loans to New England Note. In fact it was arranged for Begole to issue a letter to Belgian Trust and Belgian Bank indicating that the new CD was being held as collateral for the loans, which he did and Belgian Bank so held it thereafter. Thus Sweeny was induced through fraud to purchase a new CD which was rendered valueless to Manhattan by the acts of the schemers. The schemers made it appear that Belgian Trust owed $5,000,000 plus interest to Manhattan evidenced by the new CD, that Manhattan further had on deposit at Belgian Trust a sum in excess of $5,000,000 and New England Note owed Belgian Banking $5,250,000.

Since Sweeny insisted on keeping physical possession of the new certificate to display as the need might arise, Belgian Trust, to further conceal the true facts, issued another CD covering the same funds so that Belgian Bank might retain one to display to Bank Examiners as collateral for the renewed loan.

Furthermore, in August 1962 Belgian Trust and Belgian Banking contrived to have Sweeny return the CD that had been given to him in July and to endorse a negotiable certificate in Manhattan's name. To accomplish this the Bank official signed a letter falsely representing that the CD issued in July was being held in trust by Belgian Trust for Manhattan, whereas in fact Belgian Trust agreed to sign this letter to obtain Sweeny's endorsement of the CD. Thereafter, Belgian Banking held the CD as collateral for the loan to New England Note under the letter of instructions issued by Begole without authorization from Manhattan. The endorsement of the July CD rendered it valueless to Manhattan. Sweeny's signature as Treasurer of

Manhattan (an office he then held) was necessary to effect the collateralization and he was induced to sign only after it had been misrepresented to him that the certificate was to be held in trust and not as collateral. Sweeny, however, endorsed the certificate in his capacity as President of Manhattan which was ineffective to establish a collateralization. This was subsequently changed to "Treasurer" by another hand after the certificate was in the possession of Belgian Banking.

In August, 1962, Manhattan transmitted a CD for $500,000 drawn on the First National Bank of Boston which it owned free of all encumbrances, to Belgian Trust to be held in trust for safekeeping. However, in January 1963 the Belgian Trust CD matured and the loans (in the amount of $5,000,000 and $250,000 to New England Note and Bourne, respectively) fell due. Therefore, to continue to conceal the depletion of Manhattan's assets another series of misrepresentations was made which also resulted in the loss of this asset to Manhattan. The original plan was to effect a direct pair-off of the $5,000,000 CD against the $5,000,000 loan and to use the $500,000 CD to pay the interest on the $5,000,000 loan. The $250,000 loan was to be shipped to Boston together with the stock of Manhattan to be held by the Boston financial institution as collateral. However, this plan was discovered and thwarted by Sweeny.

Bourne, Garvin and Garvin, Bantel, Belgian Trust, Belgian Banking, Irving Trust and Begole then conspired to effect the pair-off of CD's against the loans to New England Note in the following manner. It was misrepresented to Sweeny and Manhattan that Irving Trust would issue $5,500,000 worth of CD's for the account of Manhattan and that the loans for which the Belgian Trust certificates were being held as collateral were to be refinanced. Sweeny was told to instruct Belgian Trust to deliver the

proceeds of those CD's to Irving Trust to effect payment for the new CD's to be issued by Irving Trust for Manhattan. Relying on this misrepresentation, Sweeny instructed Belgian Trust to pay the proceeds to Irving Trust. In fact, Garvin had arranged for his clearance bank, Marine Midland, to effect payment on $5,500,000 bearer certificates, which it did, and Irving Trust transmitted such certificate to Marine Midland. There they were held as collateral for the loan to Garvin by which payment was effected. Garvin then caused Irving Trust to issue a check payable to Belgian Banking in the amount of $5,250,000, presumably to pay off the loans to New England Note. However, this was nothing more than a check swap between Irving Trust, Belgian Banking, and Belgian Trust employed to make it appear that outside monies had been used to pay off the loans. Upon receipt of the Irving Trust check in the amount of $5,250,000, Belgian Trust drew a check payable to Irving Trust in the amount of $5,500,000 which represented the proceeds of the two CD's (exclusive of interest which was paid into Manhattan's account) which were now held free and clear for Manhattan since the loans for which they had been held as collateral had been paid by the Irving Trust check. This check was supposed to be released to Irving Trust to effect payment on the Irving Trust CD's pursuant to Manhattan's letter of instruction signed by Sweeny to Belgian Trust. When Irving Trust received this money, instead of crediting it to Manhattan's account it was used to offset the $5,250,000 check it had issued at Garvin's request payable to Belgian Banking and both checks were passed through the account of Garvin, Bantel.

REASONS FOR GRANTING WRIT

I.

The Court below erred in affirming the dismissal of the complaint where the record disclosed that a board of directors was fraudulently induced to authorize the sale of securities owned by a corporation and the proceeds of such sale were diverted from the corporation.

That Manhattan was the victim of a fraud was recognized both by the District Court and the Court of Appeals. Judge Herlands stated:

> "The complaint in this case presents no more than a complicated scheme of common law fraud." (App. D, p. 56a).

The majority opinion of the Court of Appeals stated:

> "What distinguishes the fraud perpetrated on Manhattan in this case from . . ." (App. A, p. 9a).
>
> • • •
>
> "No doubt the deception was successful, for had the board known that Sweeny and his associates intended to misappropriate the proceeds for their own use it undoubtedly would not have authorized their sale." (App. A, p. 10a).

The only issue to be resolved is whether or not the fraud perpetrated on Manhattan is one which is federally cognizable.

Although some facts presented in support of the claim on appeal do not appear in the complaint, the Court of Appeals properly considered them. *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 430 F.2d 355, 360

(2d Cir. 1970). The Court below rejected jurisdiction under Rule 10b-5 on the grounds that neither the purchaser nor the seller of Manhattan's bonds was deceived or defrauded with respect to the terms of the sale itself and further, that the only fraud which harmed plaintiff was the failure of the perpetrators to account for the proceeds.

A. Section 10(b) and Rule 10b-5 are violated when a board of directors is fraudulently induced to authorize the sale of securities of a corporation.

The Court recognized that the board of directors of Manhattan was induced by misrepresentations to approve the sale of bonds. The Court held, however, that since the board was deceived as to the misappropriation of the proceeds from the sale and not as to the terms of the sale (value of the bonds or the consideration paid for them), there was no violation of Rule 10b-5. The three cases cited in support of this distinction are *Ruckle* v. *Roto American Corp.*, 339 F.2d 24 (2d Cir. 1964); *Globus Inc.* v. *Jaroff*, 266 F. Supp. 524 (S.D.N.Y. 1967); and *Simon* v. *New Haven Board & Carton Co.*, 250 F. Supp. 297 (D. Conn. 1966). Each one of them upheld 10b-5 jurisdiction where the board of directors or shareholders were induced by misrepresentations of investment value into approving a sale or purchase of securities. However, there is no language in any of these decisions that limits federal jurisdiction to misrepresentations of investment value. Where it is alleged that a corporation has been defrauded into selling securities because the approval necessary for the transaction was induced by material misrepresentations of any kind, federal jurisdiction exists. Since this principle controls where the misrepresentations or omissions of material fact concern such things as the financial condition of a compeny, e.g., *Ruckle, supra; Simon, supra;* certainly where the falsehoods involved are far more outrageous in

that they conceal or fail to disclose that the seller will receive nothing for the asset it is deceived into surrendering, jurisdiction must also exist. See, *Puharich* v. *Borders Electronics Co.*, CCH FED. SEC. L. REP. ¶ 92.141 (S.D.N.Y. 1968); *Goodman* v. *Hentz & Co.*, 265 F. Supp. 440 (N.D. Ill. 1967). In *Goodman, supra* at 444-445, the Court stated:

> "The fact that the fraud was so substantial that entire transactions intended by plaintiffs to be purchases and sales for their accounts, amounted to complete conversions of their funds by Rubloff, does not deprive plaintiffs of their right to recover under the Securities Act, a right they clearly would have if Rubloff had perpetrated lesser frauds, such as misrepresentations concerning quality of stocks he recommended to them [citation omitted]; . . . . If there is any difference between the fraud in these cases and the fraud in the case at bar, it is only that the latter is more odious, because the customer loses his entire investment."

Not one cited authority indicates that jurisdiction should be denied, as did the Court below in the instant matter, if the misrepresentations inducing the transaction did not concern the terms of the sale. In fact, the judgment appealed from represents the first time a federal court has so limited the scope of Rule 10b-5. This Court has held that in the fraudulent solicitation of proxies, the fact that the misrepresentation had nothing to do with the terms of the sale or that the sale itself was fair is irrelevant for purposes of determining whether plaintiff has stated a federal cause of action. *Mills* v. *Electric Autolite Co.*, 396 U.S. 375, 90 S. Ct. 616 (1970). There, this Court stated, at 90 S. Ct. 620:

> "The result [of permitting all liability to be foreclosed on the basis of a finding that the transaction was fair] would be to insulate from private redress an entire category of proxy violations—those relating to matters other than the terms of the merger. Even outrageous misrepresentations in a proxy solicitation, if they did not relate to the terms of the transaction, would give rise to no cause of action under § 14(a). Particularly if carried over to enforcement actions by the Securities and Exchange Commission itself, such a result would subvert the congressional purpose of ensuring full and fair disclosure to shareholders."

Although *Mills, supra,* concerned proxy solicitations under section 14(a) of the Exchange Act, the same reasoning should control in Rule 10b-5 actions, especially in view of the Courts' traditional broad construction of the statutory phrase "in connection with the purchase or sale of any security." *Crane Co.* v. *Westinghouse Air Brake Co.*, 419 F.2d 787, 789 & N. 14 (2d Cir. 1969) cert. denied, 91 S. Ct. 41 (1970). To hold otherwise would insulate from private redress that entire category of misrepresentations relating to matters other than the terms of the sale—a result that this Court has already rejected. *Mills* v. *Electric Autolite Co., supra.*

In applying the "terms of the sale test", the Court conflicted with its earlier decision in *A. T. Brod & Co.* v. *Perlow,* 375 F. 2d 393 (2d Cir. 1967). There, the Court held, at 375 F. 2d 396-397:

> "Neither § 10(b) nor Rule 10b-5 contains any language which would indicate that those provisions were intended to deal only with fraud as to the investment value of securities, and, indeed, it is established that a

> 10b-5 action will survive even though the fraudulent scheme or device is unrelated to investment value. . . . Nor do we think it sound to dismiss a complaint merely because the alleged scheme does not involve the type of fraud that is 'usually associated with the sale or purchase of securities.' We believe that § 10(b) and Rule 10b-5 prohibit all fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws."

Nor can it be contended that the fraud perpetrated on the board of directors was not "in connection" with a securities transaction. It has been held that a fraud is "in connection" with a securities transaction where:

> "... the device employed, whatever it might be, be of a sort that would cause reasonable investors to rely thereon, and, in connection therewith, so relying, cause them to purchase or sell a corporation's securities."

SEC v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 860 (2d Cir. 1968) (en banc), cert. denied sub nom. *Coates* v. *SEC*, 394 U.S. 976, 89 S. Ct. 1454 (1969).

The perpetrators of the fraud recognized that in order to obtain the funds necessary to pay Bankers Life for the stock of Manhattan, the board of directors would be required to authorize the sale of bonds owned by Manhattan. These bonds were ultimately the source of funds with which Manhattan was purchased. Without the sale of the bonds (the securities transaction) there would be no acquisition; without the fraud (deception of the board) there would be no sale of bonds.

There is no logic in separating the deception of the board from the sale of securities it authorized. Indeed, the Court below accepted the fact that had the board not been deceived, it would not have authorized the sale of securities. *Supra* at 13. By limiting a federally cognizable fraud to one involving the terms of sale, the Court below has too narrowly construed the anti-fraud provisions of Rule 10b-5.

It cannot be doubted that the conduct alleged here, apart from the subsequent misappropriation of proceeds, amounting to

> "... either fraud or deceit i.e. intentional misrepresentation of facts, or to an untrue statement of material fact, or an omission to state a material fact ..." *O'Neill* v. *Maytag,* 230 F. Supp. 235, 239 (S.D.N.Y. 1964)

is a federal cognizable fraud. Although the misappropriation of the proceeds was the object of the scheme, the device used to dislodge the assets from their rightful ownership was fraud in the nature of deceit, practiced upon the decision-making body of the corporation inducing a sale of securities. This allegation of federal fraud was sufficient to defeat a motion to dismiss the complaint. See, e.g. *Ruckle, supra, Dasho* v. *Susquehanna Corp.,* 380 F.2d 262 (7th Cir. 1967) cert. denied sub nom. *Bard* v. *Dasho,* 389 U.S. 977, 88 S. Ct. 480 (1967); *Globus, supra; Dauphin Corp.* v. *Sentinel Alarm Corp.,* 206 F. Supp. 432 (D. Del. 1962).

B. Section 10(b) and Rule 10b-5 are violated when the proceeds from a sale of securities are misappropriated.

Assuming, arguendo, that the board was not induced by misrepresentations into authorizing the sale of bonds, the mere fraudulent deprivation from the seller of the consideration bargained for, even when committed by corporate insiders, is a violation of Rule 10b-5. *Puharich* v.

Borders Electronics Co., supra; Parker v. *Baltimore Paint & Chemical Corp.*, 244 F. Supp. 267 (D. Col. 1965). In *Parker, supra,* the Court noted that acts amounting to corporate mismanagement, namely, conversion of the sale price, were fraudulent acts in connection with the earlier sale of securities which in itself was pure. Thus, if the sale of bonds was not fraudulently induced, and if the proceeds from the sale were paid into Manhattan's account (assuming for the moment that Manhattan had an account), and the proceeds were then converted by corporate insiders pursuant to the scheme to pay Irving Trust for the check to Bankers Life, a violation of Rule 10b-5 would still exist. See, *Cooper* v. *North Jersey Trust Co.*, 226 F. Supp. 972 (S.D.N.Y. 1964); *United States* v. *Robertson,* 181 F. Supp. 158 (S.D.N.Y. 1959); aff'd., 298 F.2d 739 (2d Cir. 1962); *In re Calvert,* 35 S.E.C. 141 (1953); *In re Lockaby,* 29 S.E.C. 271 (1949). See also: *Allico Nat'l Corp.* v. *Amalgamated Meat Cutters,* 397 F.2d 727 (7th Cir. 1968).

The Court of Appeals found that the only fraud harmful to Manhattan was in the failure of the schemers to account for the proceeds of the sale. The Court, however, disregarded the plain fact that each fraudulent act including the misappropriation of the proceeds by defendants was a vital part of one scheme and the successful perpetration of the scheme damaged the corporation to the extent of $5,000,000. The Court below has severed the mismanagement of Manhattan from the sale of bonds and held that the mismanagement allegations standing alone do not constitute a 10b-5 case. The Court, however, is

> "not at liberty to disregard [Petitioner's] allegations and to now hold that the charges are unrelated." *Parker* v. *Baltimore Paint & Chemical Corp.*, 244 F. Supp. 267, 270 (D. Col. 1965).

As the District Court recognized:

> "The direct involvement of the deceit with a transaction in securities is fraud 'in connection with' the sale of the stock, and consequently constitutes federal fraud irrespective of whether it also constitutes corporate mismanagement." *Superintendent of Insurance* v. *Bankers Life and Casualty Co.*, 300 F. Supp. 1083, 1102-1103 (S.D.N.Y. 1969).

Violators of Rule 10b-5 are not immunized from civil liability for their unlawful acts merely because those acts were committed as part of a broader scheme of corporate mismanagement. *Herpich* v. *Wallace*, 430 F.2d 792 (5th Cir. 1970); *Kane* v. *Central American Mining & Oil, Inc.*, 235 F. Supp. 559, 564 (S.D.N.Y. 1964); *New Park Mining Co.* v. *Cranmer*, 225 F. Supp. 261, 266 (S.D.N.Y. 1963).

Thus, the misappropriation of the proceeds from the sale of Manhattan's bonds was itself a fraud in connection with a securities transaction. Even if deemed to be an act of corporate mismanagement, the misappropriation is nevertheless actionable under 10b-5 as being an act committed as part of an overall fraudulent scheme.

The resolution of the issues raised herein defines the scope of section 10(b) and Rule 10b-5 for an entire class of actions. By affirming the dismissal of the complaint, the Court of Appeals has ruled erroneously on important questions of federal securities law. They have not been but should be decided by the Supreme Court.

II.

The decision appealed from conflicts with the decision of the Court of Appeals for the Fifth Circuit in *Hooper* v. *Mountain States Securities Corp.*, 282 F.2d 195 (1960).

Petitioner is in precisely the same position as was the plaintiff in *Hooper* v. *Mountain States Securities Corp.*, 282 F. 2d 195 (5th Cir., 1960) cert. denied, 365 U.S. 814, 81 S. Ct. 695 (1961). There, a trustee in bankruptcy was recognized as a proper party to maintain an action on behalf of the corporation which had been defrauded A transfer agent was fraudulently induced to issue corporate stock by misrepresentations that a sale had occurred and was approved by the board of directors. Upon the issuance of $700,000 worth of securities by the transfer agent, the corporation was given worthless properties. No sale or approval had taken place. The Court constructed a sale to bring the case within Rule 10b-5. Although there were no misrepresentations as to the terms of the "sale", the Fifth Circuit held that the misrepresentations made to the transfer agent inducing the "sale" constituted a violation of Rule 10b-5 where the corporation received inadequate consideration. In short, all that must be established to support federal jurisdiction is injury to the corporation as a result of a fraudulent securities transaction. See, *Hoover* v. *Allen*, 241 F. Supp. 213 (S.D.N.Y. 1965); *Simon* v *New Haven Board & Carton Co.*, 250 F. Supp. 297 (D. Conn. 1966). Manhattan was injured by the sale of its securities because it received no consideration at all. By affirming the dismissal of the complaint, the Court below is therefore squarely in conflict with the decision of the Fifth Circuit in *Hooper, supra*. The writ of certiorari should be granted in order to resolve the conflict

between the decision appealed from and the decision of the Fifth Circuit in *Hooper, supra.*

III.

The purchaser-seller restriction enunciated in *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952) cert. denied, 343 U.S. 956 (1952) should be abolished.

Before reaching the question of whether Petitioner alleged a violation of Rule 10b-5 in connection with the purchase and sale of the Manhattan stock, the Court of Appeals found that since Manhattan was neither a purchaser or seller of the stock, it lacked standing to sue. The Court relied on *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952) cert. denied, 343 U.S. 956 (1952) and its reaffirmation in *Greenstein* v. *Paul*, 400 F.2d 580 (2d Cir. 1968).

The courts have recognized the artificiality of the limitation imposed by the purchaser-seller rule. See, *Hooper, supra; Vine* v. *Beneficial Finance Co.*, 374 F.2d 627 (2d Cir. 1967) cert. denied, 389 U.S. 970, 89 S. Ct. 463 (1967); *Stockwell* v. *Reynolds*, 252 F. Supp. 215 (S.D.N.Y. 1965).

Similarly the SEC has consistently argued in recent years as amicus that there is not and ought not to be a mechanical purchaser-seller test for determining standing to sue under Rule 10b-5. *Vine* v. *Beneficial Finance Co., supra; Pacific Insurance Co.* v. *Blot*, 267 F. Supp. 956 (S.D.N.Y. 1967).

Where a private right of recovery is court-created it is likewise within the proper powers of the court to determine the scope of that right. The court in *Birnbaum* relied heavily on the statement of the SEC that Rule 10b-5 closed

a loophole with regard to fraudulent purchases of securities in holding the right of action to be limited to defrauded purchasers or sellers, rather than on the legislative history of the act. The SEC originally promulgated the rule under its duty to protect the public at large and investors in securities. It would seem both judicially proper and appropriate for the courts to rely as heavily today on the position of the SEC in interpreting its own rule as they did in 1952.

Furthermore, it should be noted that Rule 10b-5 was promulgated in 1942, fully four years before a private action for fraud was recognized by the courts. The SEC was concerned at the time with those against whom actions could be brought, not those on whose behalf private actions could be brought, since no private right of action existed at the time. Thus, the SEC intended the scope of the fraud provisions to cover both purchasers and sellers, when such actions were in the public interest or for the protection of investors. The law required a consummated purchase and sale of securities before the SEC could bring an action against a defrauding party.

The Court of Appeals, however, felt it was bound by its decision in *Greenstein* v. *Paul,* 400 F. 2d 580 (2d Cir. 1968). The Court there held that it was necessary for a plaintiff to have been either a purchaser or seller of securities to sustain federal jurisdiction in an action for damages. Unlike *Greenstein, supra,* Petitioner here is not seeking a speculative recovery. Petitioner's damages were fixed by its actual losses of $5,500,000, and is thus entitled to sue in the federal courts for damages resulting from the violation of the securities laws. To hold otherwise when not demanded by law, logic, or sound principles of statutory interpretation can only serve to ossify a statutory scheme

designed to be flexible and to create greater incentive for clever scheming.

Although section 10(b) and Rule 10b-5 may well be the most litigated provisions in the federal securities laws, *SEC* v. *National Securities,* 393 U.S. 453, 465, 89 S. Ct. 564, 571 (1969), this Court has never ruled on the Birnbaum doctrine as it applies to standing. *Id.* n. 9 at 467, 89 S. Ct. at 572. Since the case at bar clearly raises the standing issue, the Court should resolve it by granting the writ of certiorari. *Id.* at 472, 89 S. Ct. 574 (dissenting opinion of Justice Harlan).

IV.

The Court of Appeals, in holding that Petitioner has not alleged a federal cause of action in connection with the transactions in certificates of deposit, has ruled erroneously on an important question of securities law that has not been but should be decided by the Supreme Court.

Subsequent to January 24, 1962, Manhattan was the victim of several separate and distinct proscribed schemes or devices over the following fifteen month period before the facts came to light and Manhattan was placed in liquidation. The schemes or devices are described in The Facts at pp. 7 through 12, *supra.*

Those issues raised in connection with the purchase and sale of Manhattan's bonds are also raised in connection with the purchase and sale of CD's subsequent to January 24, 1962. The Court of Appeals held that Petitioner failed to state a violation of Rule 10b-5 with regard to the latter set of transactions on substantially the same grounds given for denying jurisdiction regarding the events of January

24, 1962: that regardless of any fraud practiced prior to, during, or after the transactions, as long as the CD's were bought and sold for their full face amount, there was no fraud in connection with their purchase and sale within the meaning of Rule 10b-5.

Petitioner expressly incorporates herein the arguments set forth in I, *supra* establishing that the Court of Appeals has ruled erroneously on these issues and that the Supreme Court should issue a writ of certiorari to review the decision.

Furthermore, Manhattan was defrauded in connection with the sale of the $500,000 First National Bank of Boston CD. As a result of the misrepresentations to Sweeny, Manhattan's agent, the proceeds from the sale of the CD were diverted to pay off the debt of New England Note. Sweeny, as President of Manhattan, had authorized its sale only to effect payment for a new certificate. Petitioner is therefore entitled to recover on behalf of Manhattan and its creditors as a defrauded seller of securities within the meaning of section 10(b) and Rule 10b-5.

Petitioner is further entitled to recover as the defrauded purchaser of the Irving Trust CD's under section 17(a). The monies paid by Manhattan to effect payment on the CD's issued by Irving Trust were diverted and paid into the account of Garvin pursuant to the scheme, and the CD's were delivered to Marine Midland where they were held as collateral for a loan to Garvin and Garvin, Bantel.

There is only one sum of money in the amount of $5,500,000 involved in all these schemes and separate recovery for each of the separate and distinct fraudulent schemes is not demanded in excess of that amount. Nonetheless, liability would attach at any one of a number of junctures along the path that led to the liquidation of Manhattan.

At each Manhattan had an asset or a potential asset which was rendered valueless to, or the proceeds of which were diverted away from Manhattan. Indeed these fraudulent transactions, although distinct violations, can be viewed as being part of the original purchase and sale transactions of January 24, 1962. They were the direct result of the fact that Manhattan never received any consideration for its bonds sold that day.

CONCLUSION

The allegations of the complaint as amplified by the record before the Court discloses that the board of directors of Manhattan was fraudulently induced to authorize the sale of securities. The deception of the board was part of an overall scheme to loot the assets of Manhattan by selling its securities. As part of that scheme and as a separate fraudulent act in connection with the sale of securities, the proceeds from such sale were misappropriated so that Manhattan sold a valuable asset and received nothing in return.

The Court below, although recognizing the existence of a fraud, erred in not finding it to be a federally cognizable fraud under section 10(b) and Rule 10b-5. The questions raised in this Petition are of vital importance in the field of securities law and for all of the reasons set forth herein, certiorari should be granted.

Respectfully submitted,

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APPENDIX

APPENDIX A

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 631—September Term, 1969.

(Argued March 26, 1970 Decided July 22, 1970.)

Docket No. 33869

SUPERINTENDENT OF INSURANCE OF THE STATE OF NEW YORK, as Liquidator of MANHATTAN CASUALTY COMPANY,

Plaintiff-Appellant,

—v.—

BANKERS LIFE AND CASUALTY COMPANY, IRVING TRUST COMPANY, BELGIAN AMERICAN BANKING CORPORATION, BELGIAN AMERICAN BANK & TRUST COMPANY, GARVIN, BANTEL & COMPANY, GEORGE K. GARVIN,

Defendants-Appellees.

BEFORE:

LUMBARD, *Chief Judge,*

HAYS, *Circuit Judge,* and BLUMENFELD, *District Judge.**

Appeals from judgments in favor of defendants entered in the United States District Court for the Southern District of New York, Herlands, *J.*, and Ryan, *J.*, dismissing action brought under the federal Securities Acts, on the

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* Of the District of Connecticut, sitting by designation.

ground that the complaint failed to state a federal cause of action.

Affirmed.

BLUMENFELD, *District Judge*:

Appellant Superintendent of Insurance of the State of New York, as Liquidator of Manhattan Casualty Company (Manhattan), commenced this action in 1963 alleging violations by ten defendants of § 17(a) of the Securities Act of 1933. On September 10, 1968, defendants Bankers Life and Casualty Company (Bankers Life), Belgian American Bank & Trust Company (Belgian Trust), and Belgian American Banking Corporation (Belgian Banking) moved to dismiss the action before the late Judge Herlands. On October 1, 1968, defendants Irving Trust Company (Irving), Garvin, Bantel & Company (Garvin, Bantel), and George K. Garvin made similar motions before Judge Ryan. On June 4, 1969, Judge Herlands entered judgment dismissing the action as to Bankers Life, Belgian Trust, and Belgian Banking. His thorough and considered decision granting the motions of these defendants is set out at 300 F. Supp. 1083 (S.D.N.Y. 1969). Shortly thereafter, on June 17, 1969, Judge Ryan, concurring in the reasoning of Judge Herlands' opinion, entered judgment dismissing the action as to Irving, Garvin, Bantel, and George K. Garvin. It is from these judgments that the Superintendent appeals. We affirm.

I. *Facts*

Manhattan was a casualty insurance company wholly owned by defendant Bankers Life and operated by it as a subsidiary. In January 1962 two individuals, defendants

Appendix A

Standish T. Bourne and James F. Begole, both now deceased, and not involved in this appeal, agreed to purchase all the stock of Manhattan. On January 19, 1962, a contract was executed between Begole as purchaser and Bankers Life as seller, providing for the sale of the Manhattan stock for $5,000,000 on January 24, 1962. On that day, Begole, John F. Sweeny[1] and C. Joseph Gunter, an officer of Irving, went to Manhattan's office for the closing. Pursuant to plans made in advance of the closing, Gunter tendered an Irving check for $5,000,000 to an officer of Bankers Life and, in exchange, all of the shares of Manhattan stock were given to Begole.

This transaction between Bankers Life and Begole still remains unchallenged because neither the former, as seller, nor the latter, as buyer, has brought any action seeking damages or any relief, one against the other. In this lawsuit our attention has been shifted away from that conventional purchase and sale of the Manhattan stock to the legerdemain employed by the buyer to obtain the $5,000,000 with which to pay for the stock.[2]

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[1] At oral argument in the district court, it was learned that Manhattan ousted Sweeny from the presidency of Manhattan at about the time that Bankers Life decided to sell the Manhattan stock, and that subsequent to the ouster Sweeny established contact between Begole and Bourne and Bankers Life. Judge Herlands concluded:

> "Probably at that time, Sweeny also arranged with Begole and Bourne that he should be reinstated as president of Manhattan when, and if, Begole and Bourne acquired control of Manhattan." 300 F. Supp. at 1087 and n. 4.

[2] The details of financing the purchase of Manhattan stock were apparently the responsibility of Bourne. He engaged the services of defendant George K. Garvin and the latter's firm of money brokers (Garvin, Bantel), who had arranged in advance for the above transaction as well as those to follow.

Appendix A

Following the closing, but on the same day, United States Government securities (Treasury bonds) from Manhattan's portfolio were sold [3] and the proceeds, amounting to $4,854,552.67, plus enough cash to bring the total to $5,000,000, were credited to an account in the name of Manhattan at Irving, and the $5,000,000 Irving check was then charged against this account. As a result of this first series of transactions, Bankers Life had received $5,000,000 in exchange for the Manhattan stock, Begole and Bourne owned the stock, and Manhattan's assets, having been used to purchase the Manhattan stock, had consequently been reduced by $5,000,000.

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[3] The complaint is silent as to the source of authority for this sale of securities from Manhattan's portfolio. Noting that fact, Judge Herlands stated:

> "Conceivably it was [Sweeny, apparently installed as president of Manhattan after the stock changed hands] who directed the Chemical Bank to deliver Manhattan's portfolio of . . . securities to Irving Trust, authorized the sale of these securities, and then transferred Manhattan cash to Irving Trust in order to cover completely the $5,000,000 Irving Trust check payable to Bankers Life." 300 F. Supp. at 1089.

He also noted the possibility that a board of directors might have been named, which in turn met and appointed Sweeny as president and granted him authority to effect the transactions on Manhattan's behalf. *Id.* at 1089 n. 6.

Appellant vigorously contends that this represents a serious misunderstanding of fact vital to his theory of recovery. His contention is that the sale of Treasury bonds was authorized by resolution of the board of directors on the basis of a representation that the sale of bonds and purchase of a certificate of deposit was merely a change in the company's investment portfolio. Although every minute detail of the pretenses used by Begole and his associates to mask their fraudulent activity may not have been adduced from the complaint or from the other parts of the record as augmented after some six years of discovery, we are satisfied that the able district judges overlooked nothing that would affect the character of the claim.

Appendix A

In order to conceal the depletion of Manhattan's assets,[1] the individuals now in control of Manhattan had a neatly prepared ruse ready at hand. At Garvin's request, Irving issued a second check for $5,000,000 payable to Belgian Trust. Sweeny, president of Manhattan, used this check to buy a $5,000,000 six-month's certificate of deposit from Belgian Trust payable to Manhattan. That certificate was then endorsed by Sweeny as president of Manhattan to New England Note Corporation (New England) and delivered to Bourne, president of New England. Bourne then endorsed and delivered it to Belgian Banking as collateral for a six-month's $5,000,000 loan from Belgian Banking to New England. The proceeds of this loan were then delivered to Irving to cover its $5,000,000 check drawn to the order of Belgian Trust.

To recapitulate, there were two sets of telescoped transactions—all completed on the same day:

A. All of Manhattan's shares were purchased from Bankers Life for $5,000,000, borrowed from Irving. After thus gaining control of Manhattan, the purchaser sold government bonds out of Manhattan's portfolio and used the proceeds to pay off the loan from Irving.

B. To conceal the above depletion of Manhattan's assets, the new owners of Manhattan and those they put in control arranged for a second loan from Irving for $5,000,000. With this they bought a $5,000,000 certificate of deposit from Belgian Trust in the name of Manhattan, and assigned that to New England (Bourne). New England en-

[1] The financial ability of corporations engaged in the business of liability insurance to meet claims against its policyholders is subject to regulation under the laws of New York. Their books are open to regular inspection by experts in that business employed by the insurance department of the State of New York.

dorsed it to Belgian Banking as security for a $5,000,000 loan to New England. The proceeds were then used to repay Irving's second loan. However, Manhattan's books reflected only the sale of its government bonds and the purchase of the certificate of deposit. Manhattan's records did not show (1) that the proceeds of the sale of these bonds were used by Begole to pay for his purchase of Manhattan's shares or (2) that the certificate of deposit had been assigned to New England and by it pledged to Belgian Banking.

The loans and certificates outlined in *B.* were twice renewed. The first renewal was in July 1962. In January 1963, when Belgian Banking refused to renew its loan to New England a similar round robin set of transactions was effected by substituting Marine Midland Trust Company to perform Belgian Banking's role. In April 1963 the New York Insurance Department discovered the inadequacy in Manhattan's assets and placed the company in liquidation.

II. *Appellant's Claims*

The complaint alleges that the foregoing related transactions constituted one or more violations of § 17(a) of the 1933 Act, 15 U.S.C. § 77q(a).[5] The district court properly considered as well the applicability to the pleaded facts

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[5] Section 17(a) provides:

"It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

"(1) to employ any device, scheme, or artifice to defraud, or

"(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the

of § 10(b) of the 1934 Act, 15 U.S.C. § 78j(b)[6] and of S.E.C. Rule 10b-5[7] promulgated thereunder. See *Hoover* v. *Allen*, 241 F. Supp. 213, 226 n. 7 (S.D.N.Y. 1965). On appeal, appellant claims the pleaded facts, as well as those otherwise contained in the record, establish his right to recover under one or both of these sections for fraud perpetrated (1) in connection with the purchase and sale of the Manhattan stock, (2) in connection with the sale of Treasury bonds from Manhattan's portfolio, and (3) in connection

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light of the circumstances under which they were made, not misleading, or

"(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

[6] Section 10(b) provides:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securites exchange—

* * * * * *

"(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

[7] Rule 10b-5 provides:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

"(1) to employ any device, scheme, or artifice to defraud,

"(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

"(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

"in connection with the purchase or sale of any security."

with transactions involving certificates of deposit and occurring after January 24, 1962. We disagree and affirm the decision of the district court.

III. *Sale of Manhattan Stock*

Section 17(a) of the 1933 Act provides a cause of action only for a defrauded purchaser. *Schoenbaum* v. *Firstbrook*, 268 F. Supp. 385, 396 (S.D.N.Y. 1967), *aff'd*, 405 F.2d 200 (2d Cir.), *rev'd in part on other grounds*, 405 F.2d 215 (2d Cir. 1968) (*en banc*), *cert. denied* sub nom. *Manley* v. *Schoenbaum*, 395 U.S. 906 (1969). Section 10(b) of the 1934 Act and Rule 10b-5 extend a similar right to a defrauded seller as well as to a purchaser of securities. *Greenstein* v. *Paul*, 400 F.2d 580, 581 (2d Cir. 1968); *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461, 463 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952); see *Christophides* v. *Porco*, 289 F. Supp. 403, 406 (S.D.N.Y. 1968).[8] Bankers Life was the seller of the Manhattan stock; Begole the purchaser. There is no theory under which Manhattan, in whose shoes this appellant stands, may be regarded as either the purchaser or the seller of Bankers Life's Manhattan stock. Consequently the appellant does not fall within the classes of those for whom a cause of action is created either by § 17(a) of the 1933 Act or § 10(b) of the

[8] Although there has been some judicial expansion of the category of persons who may be considered "purchasers," cf. *A. T. Brod & Co.* v. *Perlow*, 375 F.2d 393 (2d Cir. 1967), or "sellers" see *Vine* v. *Beneficial Fin. Co.*, 374 F.2d 627 (2d Cir.), *cert. denied*, 389 U.S. 970 (1967); *Hooper* v. *Mountain States Sec. Corp.*, 282 F.2d 195 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961), nothing in the cited cases undermines the now well-settled purchaser-seller rule of *Birnbaum*, especially in view of its recent reaffirmation in *Greenstein*. But see, *Weitzen* v. *Kearns*, 271 F. Supp. 616, 622 (S.D.N.Y. 1967); *Entel* v. *Allen*, 270 F. Supp. 60, 69 (S.D.N.Y. 1967).

1934 Act for damages incurred as a result of that transaction.

IV. *Sale of Manhattan's Treasury Bonds*

Another thrust of this appeal is that the district court erred in holding that no federal cause of action was stated with respect to the purchase or sale of Treasury bonds from Manhattan's portfolio. Appellant's claim that Manhattan is entitled to federal relief as the defrauded seller of those bonds was presented to the district court only as "amendatory allegations presented in open court and not formally set forth in the complaint." 300 F. Supp. at 1098. Moreover, the alleged facts presented in support of the claim on appeal do not appear anywhere in the complaint. *See* note 3, *supra*. Assuming that they are properly before us, and also that they are true, *Kossick* v. *United Fruit Co.*, 365 U.S. 731, 732 (1961), we hold that appellant has not made out a claim cognizable under the federal Securities Acts.

Briefly stated, appellant's claim is that a majority of the board of directors of Manhattan was deceived by misrepresentations of other members of the board and some of the defendants that the sale of the bonds was intended only to effectuate a substitution of those assets for a certificate of deposit equal in value; that in fact the certificate of deposit so substituted was collateralized to its full face value in favor of an unrelated corporate entity; and that on the basis of the fraudulent representations, the board was deceitfully induced to authorize the sale of the bonds in exchange for a certificate without value to the corporation.

What distinguishes the fraud perpetrated on Manhattan in this case from one cognizable under Rule 10b-5 is that

its sole object was to obtain possession of Manhattan's government bonds for the personal use of the perpetrators. No doubt the deception was successful, for had the board known that Sweeny and his associates intended to misappropriate the proceeds for their own use it undoubtedly would not have authorized their sale. But that deception did not infect the subsequent sales transaction. With respect to the terms of the sale itself neither the purchaser nor the seller of the bonds was deceived or defrauded. Cf. *Ruckle* v. *Roto Am. Corp.*, 339 F.2d 24 (2d Cir. 1964); *Globus, Inc.* v. *Jaroff*, 266 F. Supp. 524 (S.D.N.Y. 1967); *Simon* v. *New Haven Board & Carton Co.*, 250 F. Supp. 297 (D. Conn. 1966). Indeed, it is no part of the liquidator's claim that the full and fair market price was not paid for those bonds by their purchaser. The fraud which harmed the plaintiff consisted of the failure of Sweeny and his associates to account for the proceeds. There is a structural difference between the sale of the corporation's bonds at a concededly fair price and the subsequent fraudulent misappropriation of the proceeds received.

Rule 10b-5 was not intended to provide a remedy for schemes amounting to no more than "fraudulent mismanagement of corporate affairs." *Birnbaum* v. *Newport Steel Corp.*, *supra*, 193 F.2d at 464. The scope of the rule must be assessed in light of the purposes of the legislation from which it derives, which we recently found to be "to promote free and open public securities markets and to protect the investing public from suffering inequities in trading . . ." *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 858 (2d Cir. 1968) (*en banc*), *cert. denied* sub nom. *Coates* v. *SEC*, 394 U.S. 976 (1969). In that case, we construed the "in connection with" requirement of Rule 10b-5 as follows:

> "Therefore it seems clear from the legislative purpose Congress expressed in the Act, and the legislative history of Section 10(b) that Congress when it used the phrase 'in connection with the purchase or sale of any security' intended only that the device employed, whatever it might be, be of a sort that would cause reasonable investors to rely thereon, and, in connection therewith, so relying, cause them to purchase or sell a corporation's securities." *Id.* at 860.

See *Heit* v. *Weitzen*, 402 F.2d 909, 913 (2d Cir. 1968), *cert. denied*, 395 U.S. 903 (1969).

The fraud alleged in this case in no way affected either the securities markets or the investing public. No stockholders were defrauded, no investor injured. The purity of the security transaction and the purity of the trading process were unsullied. There was no danger that the securities sold would be overvalued on reaching the public markets. Cf. *Ruckle* v. *Roto Am. Corp., supra,* 339 F.2d at 28.

Despite the power of the Commission to promulgate rules "appropriate in the public interest or for the protection of investors," §78j(b), the scope of the rule in fact promulgated is expressly limited to protection against fraud or deceit "in connection with the purchase or sale of any security." Rule 10b-5. Although in the broadest sense the public interest is involved when a corporation which is subject to regulation by the state Superintendent of Insurance is defrauded, the public interest cognizable by §10(b) is limited to preserving the integrity of the securities markets. The civil liberties provisions of the federal Securities Acts, beginning in 15 U.S.C. §77(*l*) were "part of a broad integrated program designed to obtain

honest dealings in securities," *Wilko* v. *Swan*, 127 F. Supp. 55, 58 (S.D.N.Y. 1955), not one to create an unlimited federal right of action for damages for all who have been defrauded in any area of economic activity. The condition imposed by Rule 10b-5 that the fraud be in connection with the purchase or sale of a security is wholly consistent with that program. Thus, we do not decide that the creditors of Manhattan do not have any remedy under general state tort law for the fraud practiced on their debtor, but only that the federal Securities Acts have not provided a federal forum for its enforcement.

V. *Transactions Involving Certificates of Deposit*

Appellant also contends that Manhattan was defrauded in connection with both purchases and sales of various six-month certificates of deposit exchanged after January 24, 1962. These transactions, which were integral parts of the scheme [9] to conceal the prior depletion of Manhattan's assets, are sufficiently described in the opinion below and need not be fully restated here. The conclusion we have reached that the sale of Manhattan's Treasury bonds did not present a federal cause of action applies equally to these transactions. The certificates of deposit or their proceeds may have been fraudulently misapplied, but there was no fraud in connection with their purchase or sale. In each instance they were bought and sold for their full face amount.

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[9] Although the plaintiff contends that it is clear that liability would attach at any one of a number of junctures along the path that led to the liquidation of Manhattan, it expressly disclaims the right to separate recoveries for each of these "separate and distinct fraudulent schemes."

Since we have considered those facts appellant would include in an amendment of his complaint in reaching our conclusion that a claim for relief under the federal Securities Acts is not alleged, we also affirm the district court's denial of the motion to amend.

Affirmed.

HAYS, *Circuit Judge* (dissenting):

Plaintiff has succeeded to all the rights of Manhattan and is the proper person to assert those rights. See *Hooper* v. *Mountain States Securities Corp.*, 282 F.2d 195, 206-07 (5th Cir. 1960), cert. denied, 365 U.S. 814 (1961), where plaintiff was the defrauded corporation's trustee in bankruptcy.

Manhattan was the victim of a "scheme . . . to defraud" (Rule 10b-5). Judge Blumenfeld has adequately described that scheme. Since the vital center of the scheme, the vehicle for the perpetration of the fraud, was the sale of Manhattan's stock, it seems to me to be completely unrealistic to say that the fraud was not committed "in connection with the purchase or sale of any security."

This court has repeatedly indicated its intention to give a broad and liberal interpretation to Rule 10b-5 in order to assure that that provision is used to accomplish the beneficent purposes for which the statutes governing sales of securities were enacted. See *Ruckle* v. *Roto American Corp.*, 339 F.2d 24 (2d Cir. 1964); *Vine* v. *Beneficial Finance Co.*, 374 F.2d 627 (2d Cir.), cert. denied, 389 U.S. 970 (1967); *A. T. Brod & Co.* v. *Perlow*, 375 F.2d 393 (2d Cir. 1967); *S.E.C.* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (*en banc*), cert. denied sub nom. *Coates* v. *S.E.C.*, 394 U.S. 976 (1969); *Schoenbaum* v. *Firstbrook*,

405 F.2d 215 (2d Cir. 1968) (*en banc*), cert. denied sub nom. *Manley* v. *Schoenbaum*, 395 U.S. 906 (1969); *S.E.C.* v. *Great American Industries, Inc.*, 407 F.2d 453 (2d Cir. 1968) (*en banc*), cert. denied, 395 U.S. 920 (1969). In our most recent expression on the subject, we said that "[t]he purchase-sale requirement must be interpreted so that the broad design [of the statutes] . . . is not frustrated by the use of novel or atypical methods" and we quoted from *S.E.C.* v. *Texas Gulf Sulphur, supra*, the following language *inter alia*: "the courts, as they should, have broadly construed the statutory phrase 'in connection with the purchase or sale of any security.'" *Crane Co.* v. *Westinghouse Air Brake Co.*, 419 F.2d 787, 798 & n. 14 (1969).

In my opinion, the purposes of the statutes would be best accomplished here by recognizing plaintiff's standing to enforce the duties created by those statutes.

APPENDIX B

33869

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

SUPERINTENDENT OF INSURANCE OF THE STATE OF NEW YORK, as Liquidator of Manhattan Casualty Co.,

Plaintiff-Appellant,

—v.—

BANKERS LIFE AND CASUALTY COMPANY, *et al.*,

Defendants,

BANKERS LIFE AND CASUALTY CO., *et al.*,

Defendants-Appellees.

A petition for a rehearing having been filed herein by counsel for the appellant,

Upon consideration thereof, it is

Ordered that said petition be and it hereby is DENIED.

J. EDWARD LUMBARD

M. JOSEPH BLUMENFELD
per J.E.L.

I dissent and vote for rehearing

/s/ PAUL R. HAYS

September 30, 1970

APPENDIX C

33869

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

SUPERINTENDENT OF INSURANCE OF THE STATE OF NEW YORK,
as Liquidator of Manhattan Casualty Co.,

Plaintiff-Appellant,

—v.—

BANKERS LIFE AND CASUALTY COMPANY, *et al.*,

Defendants,

BANKERS LIFE AND CASUALTY CO., *et al.*,

Defendants-Appellees.

A petition for a rehearing containing a suggestion that the action be reheard in banc having been filed herein by counsel for the appellant and no active circuit judge having requested that a vote be taken on said suggestion,

Upon consideration thereof, it is

Ordered that said petition be and it hereby is denied.

J. EDWARD LUMBARD
Chief Judge

September 30, 1970

APPENDIX D

UNITED STATES DISTRICT COURT

FOR THE SOUTHERN DISTRICT OF NEW YORK

63 Civ. 2490—June 3, 1969

SUPERINTENDENT OF INSURANCE OF THE STATE OF NEW YORK, as Liquidator of Manhattan Casualty Co.,

Plaintiff,

—v.—

BANKERS LIFE AND CASUALTY COMPANY, Irving Trust Company, Belgian American Banking Corporation, Belgian American Bank & Trust Company, Garvin, Bantel & Company, New England Note Corporation, George K. Garvin, John F. Sweeny, the Estate of Standish T. Bourne, by Standish T. Bourne, Jr., as Executor, the Estate of James F. Begole, by Patricia C. R. Begole, Executrix,

Defendants.

HERLANDS, *District Judge*:

The issue for decision is another illustration of the recurring problem whether plaintiff's claim belongs in the state courts or whether plaintiff has stated a cause of action under the federal securities laws—the Securities Act of 1933 (1933 Act), 15 U.S.C. §§77 *et seq.* (1964) and the Securities Exchange Act of 1934 (1934 Act), 15 U.S.C. §§78 *et seq.* (1964), and the pertinent rules and regulations of the Securities and Exchange Commission. This question is posed by motions made by three of the defendants to dismiss the complaint.

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The movants are defendants Bankers Life and Casualty Company ("Bankers Life"), Belgian American Banking Corporation ("Belgian American Banking"), and Belgian American Bank and Trust Company ("Belgian American Trust").

The grounds of the motions are (1) that there is lack of jurisdiction over the subject matter; (2) that the complaint fails to state a claim upon which relief can be granted; and (3) that plaintiff lacks the requisite standing to recover damages for alleged violations of the 1933 and 1934 Acts.

Defendants maintain that plaintiff may not recover because (i) it[1] is neither a defrauded purchaser nor a defrauded seller of securities within the meaning of the 1933 and 1934 Acts, and (ii) these federal statutes have never been and should not be interpreted so as to make them applicable to remedy the injury allegedly resulting from the facts asserted in the complaint. A comprehensive restatement of the facts alleged in the complaint is requisite for a comprehension of the following discussion of the critical legal issues.[2]

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[1] The Superintendent of Insurance of the State of New York is the nominal plaintiff. Since he, as Liquidator, has been vested with all rights of the Manhattan Casualty Company (hereinafter "Manhattan"), the rights he seeks to assert are precisely those possessed by Manhattan at the time of his appointment as Liquidator. Consequently, the questions of standing to initiate suit and of injury will be determined as if Manhattan itself had brought suit.

[2] These motions were made pursuant to an order entered by District Judge Sylvester J. Ryan on June 19, 1968 denying, without prejudice, a motion for summary judgment under Fed. R. Civ. P. 56(b), (c) because subject matter jurisdiction was doubtful. In light of that motion and its disposition, this Court will not treat the instant motions as motions for summary judgment by looking outside the face of the pleadings. The Court will rule on the questions of jurisdiction and the sufficiency of the complaint solely on the basis of its allegations.

The complaint, however, does not contain "a short and plain statement" (Fed. R. Civ. P. 8(a)) of the claim; its averments are

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EVENTS PRIOR TO JANUARY 24, 1962

Manhattan Casualty Company ("Manhattan") was a New York corporation engaged in the insurance business. At the beginning of the period under consideration, Bankers Life was the owner of all of the outstanding shares of Manhattan stock. The management of Manhattan apparently was distinct from that of Bankers Life.

During the fall of 1961, Bankers Life decided to discontinue its ownership of Manhattan. Sometime in November, 1961,[3] Bankers Life, through James W. Bourland, a vice-president of Bankers Life, commenced negotiations for the sale of all the Manhattan stock. The prospective purchasers were two individuals, defendants Standish T. Bourne and James F. Begole. (¶19).

At about the time that Bankers Life decided to sell its Manhattan stock, it ousted the defendant John F. Sweeny from the presidency of Manhattan.[4] Sweeny, however, established contact betwen Begole and Bourne and Bankers

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not "simple, concise and direct" (Fed. R. Civ. P. 8(e)); and the intricacies of the pleaded transactions cannot immediately be interrelated.

As a consequence, the Court has been compelled to undertake the task of describing the sequence of events as coherently as the complaint permits. The Court has noted, when necessary, the gaps in the narrative which were filled through other sources (these facts not playing a part in the disposition of the motions) and those gaps which remain void.

[3] Paragraph 18 of the complaint alleges that the acts in furtherance of and connection with the scheme to defraud were commenced in November, 1962. However, it is obvious from the succeeding paragraphs that this date is a typographical error, and that the correct date is November, 1961.

[4] This information was conveyed to the Court at oral argument (Transcript, September 10, 1968 at 23-25). Sweeny's former relationship with Manhattan, his discharge by Bankers Life, and his subsequent connection with Bourne and Begole, are important for an understanding of the alleged fraud.

Life. Probably at that time, Sweeny also arranged with Begole and Bourne that he should be reinstated as president of Manhattan when, and if, Begole and Bourne acquired control of Manhattan.

The negotiations drew to a successful conclusion. On January 19, 1962, a contract for the purchase and sale of all the Manhattan shares was entered into by Bankers Life (still through Bourland, as its vice-president) and Begole, individually. Begole, alone and in his own name, was to purchase the Manhattan shares. He agreed to deliver to Bankers Life at the closing on January 24, 1962 a bank check or certified check in the amount of $5,000,000. (¶20).

The complaint does not charge that any misrepresentations, deceit or non-disclosures had been made or practiced upon any party in connection with this contract of purchase and sale. The complaint is devoid of allegations respecting the net worth of Manhattan or its general financial position; thus, there is nothing upon which to base any finding as to the equity or unfairness of the contract.

Financing

Sometime after January 19, 1962 but before the closing date (January 24, 1962), Bourne had stated to Begole that he, Bourne, would arrange for the financing of the stock acquisition. (¶21). Bourne made contact with defendant George K. Garvin (a partner in the note brokerage firm Garvin, Bantel & Company, also a party defendant) and asked Garvin to have a bank issue certificates of deposit in the face amount of $5,000,000 and then to have a bank make a loan, using the certificates as collateral. (¶22). Other than the conclusory statement that the purpose of these two transactions was to conceal the scheme to defraud, there is nothing in the complaint's factual allegations that

would explain the significance of these two transactions which, taken together, appear to be self-cancelling.

Acting upon Bourne's request, Garvin, prior to January 24, 1962, arranged with Belgian American Trust to issue a certificate of deposit in the face amount of $5,000,000, in the name of Manhattan. (¶23). The complaint is silent, however, as to whether Belgian American Trust was informed of the method of payment for this certificate of deposit. Presumably, it was so informed. Garvin also arranged with Belgian American Baking to loan to defendant New England Note Corporation—a company controlled by Bourne—$5,000,000 upon the collateral of the certificate of deposit that would be issued in the name of Manhattan. (¶23).

Also in preparation for the closing of January 24, 1962, Garvin met with C. Joseph Gunther, an officer of defendant Irving Trust Company. Gunther agreed to bring to Garvin's office on January 24, 1962 a check in the amount of $5,000,000 payable to Bankers Life. This check was to be paid for by the delivery of various securities from Chemical Bank New York Trust Company to Irving Trust Company. (¶24).

TRANSACTIONS OF JANUARY 24, 1962

The Closing, the Payment for the Manhattan Shares, and the Sale of Manhattan's Portfolio

On the morning of January 24, 1962, Bourne, Sweeny, Begole, and Gunther appeared at Garvin's office. Begole then executed two notes,[5] both payable to New England

[5] There are no allegations respecting the obligor, *i.e.*, whether these were personal notes of Begole or were to become obligations of Manhattan. It seems more likely that they were personal obligations of Begole because of the assignment of the shares by Begole to New England Note Corporation, which may have been intended as an assignment for security purposes.

Note Corporation. One was in the amount of $5,000,000, interest payable at 7½ per cent; the other in the amount of $250,000, interest payable at 5 per cent. The complaint is silent as to whether these notes were delivered. Begole also executed in favor of New England Note Corporation an assignment of the Manhattan stock that he would receive. (¶25). The economic purpose underlying these transactions is neither explained nor readily discernible.

Sweeny, Begole, Garvin, and Gunther then went to Manhattan's office for the closing of the sale of Manhattan stock. Gunther handed the $5,000,000 Irving Trust Company check to Leo Lehane, an executive vice-president of Bankers Life, and received in return an unsealed envelope. (¶26). The complaint contains no other allegations pertaining to the actual closing. It would be sheer speculation to assume that the envelope did or did not contain the shares of Manhattan stock.

Nevertheless, Begole and Bourne presumably did obtain possession of the shares of Manhattan stock at some point because (as will be detailed later) these shares apparently were physically tendered as security for a loan.

Once the ownership of the shares of Manhattan stock apparently changed hands on January 24, 1962, the following took place: United States Government securities owned by Manhattan, in the face amount of $5,155,000, were delivered through Garvin, Bantel & Company to Irving Trust Company.

During the same day of January 24, 1962, Garvin, Bantel & Company sold these securities for Manhattan's account. Irving Trust Company delivered these securities to the purchaser and received the proceeds of $4,854,552.67, which amount it then credited to an account in Manhattan's name.

Manhattan (by some person not named) then transferred some cash to Irving Trust Company, which amount was also credited to this Manhattan account.

Finally, the $5,000,000 check of Irving Trust Company that Gunther had handed to Leo Lehane of Bankers Life was charged against this same Manhattan account in Irving Trust Company (¶27)—which had been built up by the crediting of the proceeds of the sale of Manhattan's portfolio of United States Government securities plus the additional Manhattan cash.

The net effect of the foregoing series of financial manoeuvres appears to be, up to this point, as follows:

(i) Bankers Life received $5,000,000 in cash for which it had ostensibly delivered all of its Manhattan stock;

(ii) Presumably, Begole (or possibly Bourne—through New England Note Corporation—as a result of Begole's prior assignment of the Manhattan stock Begole would receive) owned all of the stock of Manhattan;

(iii) Manhattan's portfolio of United States Government securities had been sold off;

(iv) Manhattan transferred some cash to Irving Trust, thereby further building up its account;

(v) Irving Trust applied the total credit—created out of the Manhattan portfolio proceeds and the Manhattan cash—to the payment of the $5,000,000 Irving Trust check which Gunther had given Lehane of Bankers Life;

(vi) As a result, Manhattan's net assets were diminished by approximately $5,000,000; and

(vii) Payment of $5,000,000 to Bankers Life for the purchase of its Manhattan stock was effected by using Man-

hattan's own assets to pay for all of its stock, which Begole or Bourne thereby obtained without using a dollar of their own money.

Though the complaint is devoid of factual allegations on the point, apparently Sweeny assumed the office of president of Manhattan immediately after the acquisition of the Manhattan shares.[6] Conceivably it was he who directed the Chemical Bank to deliver Manhattan's portfolio of United States Government securities to Irving Trust, authorized the sale of these securities, and then transferred Manhattan cash to Irving Trust in order to cover completely the $5,000,000 Irving Trust check payable to Bankers Life.

The complaint is explicit, however, in charging that Sweeny, in his capacity as president of Manhattan, effected other transactions on January 24, 1962.

The Certificates of Deposit

Later that day, Gunther, at the request of Garvin, Bantel & Company, brought another Irving Trust check in the amount of $5,000,000, payable to Belgian American Trust, to the offices of Belgian American Trust. Gunther gave the check to Sweeny who delivered it to someone at Belgian American Trust. Belgian American Trust then issued a six-months certificate of deposit in the amount of $5,000,000 in the name of Manhattan, pursuant to Garvin's prior dis-

[6] In light of allegations that Bourne was required by Irving Trust, through Garvin, to execute certain backdated letters (¶32) and that Irving Trust made various entries after January 24, 1962 for the purpose of concealing the transactions of January 24, 1962 (¶31), the absence of any similar allegations respecting Sweeny's grant of authority might indicate that Begole, in fact, did immediately name a board of directors, which met and appointed Sweeny as president, granting him sufficient authority to effect the various transactions on Manhattan's behalf.

cussions with Belgian American Trust. Sweeny received the certificate of deposit and, in his capacity as president of Manhattan, immediately endorsed it to New England Note Corporation. (¶28).

Bourne, as president of New England Note Corporation, accepted the certificate of deposit from Sweeny; and, in turn, Bourne endorsed the certificate to Belgian American Banking.[7]

Belgian American Banking then made a six-months loan of $5,000,000 to New England Note Corporation and took possession of the certificate of deposit as collateral.

Belgian American Banking drew a $5,000,000 check, apparently payable to Irving Trust Company and delivered it to Gunther. (¶28).

To recapitulate for a moment at this point:

(1) Irving Trust Company in effect exchanged its $5,000,000 check payable to Belgian American Trust for a $5,000,000 check drawn by Belgian American Banking, payable to Irving Trust Company.

(2) Belgian American Trust issued a $5,000,000 certificate of deposit which in reality was paid for by the $5,000,000 emanating from Belgian American Banking in the form of the loan in the same amount made by Belgian American Banking to New England Note Corporation and collateralized by the very same $5,000,000 certificate of deposit of Belgian American Trust.

(3) The certificate of deposit issued by Belgian American Trust was issued in the name of Manhattan, though Man-

[7] The exact relationship between Belgian American Banking and Belgian American Trust was never explained in the complaint, nor at oral argument nor in counsel's briefs. It does not appear that, for purposes of these motions, this information is crucial.

hattan did not pay for it and was in fact only an intermediate conduit for this certificate of deposit as it made its way from Belgian American Trust to Belgian American Banking.

At the same time that Belgian American Banking made the $5,000,000 loan to New England Note Corporation, it made another loan of $250,000 to New England Note Corporation and received as security the Manhattan shares assigned by Begole to New England Note Corporation. (¶28). Once again the complaint is not precise and does not allege specifically whether the Manhattan shares were actually delivered to Belgian American Banking.

The proceeds of this $250,000 loan were deposited in Belgian American Trust and the following amounts totalling $225,000 were disbursed: Garvin, Bantel — $25,000; Begole — $50,000; Bourne — $50,000; Belgian American Banking — $100,000. (¶28) It would be suppositious to attempt any explanation for the payment of the above $225,000. The complaint does not allege that this transaction constituted fraud, but only that the various transactions with the Belgian American banks were effected for the purpose of concealing the fact that Manhattan's assets had been reduced by the sale of its securities—a fact which does, indeed, emerge clearly from the above labyrinthine transactions.

Events Subsequent to January 24, 1962

The complaint alleges other events which occurred subsequent to January 24, 1962, such as the making of entries by Irving Trust Company for the purpose of concealing the transactions of January 24, 1962 (¶31); and, for similar purposes, the execution by Bourne of various backdated letters which were given to Garvin on January 29, 1962 (¶32).

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On July 24, 1962, the six-months certificate of deposit matured; the loan by Belgian American Banking to New England Note Corporation and the loans by New England Note Corporation to Begole fell due. Belgian American Trust then issued a new six-months certificate of deposit in Manhattan's name in the amount of $5,000,000. This certificate was endorsed by Begole (as chairman of Manhattan) and Sweeny (as treasurer) and posted as collateral for the Belgian American Banking-New England Note Corporation loans which were then extended to January 24, 1963. (¶33). The Manhattan stock at this point appears to be physically in the possession of Belgian American Banking as collateral for the loans. Finally, Begole's loans ($5,000,000 and $250,000) from New England Note Corporation were also extended to January 24, 1963. (¶33). It is alleged that these transactions were entered into for the purpose of furthering the scheme to defraud. (¶33).

While it would appear from the foregoing that Belgian American Banking was in possession of the $5,000,000 certificate of deposit, on August 30, 1962 Sweeny (in his capacity as president of Manhattan) wrote Belgian American Trust that he was forwarding to Belgian American Trust a non-negotiable certificate of deposit in the amount of $5,000,000 which was to be paid at maturity into Manhattan's current account at Belgian American Trust. Sweeny also stated that he was forwarding a non-negotiable certificate of deposit in the amount of $500,000 issued by the First National Bank of Boston, which certificate was to be held by Belgian American Trust in safekeeping. There are no allegations respecting the purchaser of this certificate, the source of funds for its issuance, nor any fraudulent activity in connection with it. Again, the complaint alleges that the purpose of this legerdemain was to conceal the actual reduction in Manhattan's assets and to create

the misleading impression that Manhattan had $5,500,000 more in unencumbered assets than it, in fact, did have. (¶34).

Repayment of Belgian American Banking Loans

Sometime in January, 1963, Belgian American Banking made known that it would not renew or extend its loans to New England Note Corporation, which notes fell due on January 24, 1963. (¶35). Accordingly, beginning on or about January 20, 1963, Bourne and Begole initiated another series of camouflaging transactions.

Firstly, Bourne asked Garvin, Bantel to arrange to replace the certificates of deposit which undoubtedly had been carried as assets upon Manhattan's books and the proceeds of which would be required to repay the Belgian American Banking loans. Garvin, Bantel borrowed $5,500,000 from Marine Midland Bank and Trust Co. and delivered the funds to Irving Trust Company. Irving Trust Company, on January 21, 1963, issued, at Begole's request, certificates of deposit in the amount of $5,500,000, apparently with Manhattan as payee.[8] These certificates were delivered to Garvin, Bantel. (¶36).

Secondly, on January 25, 1963, Belgian American Trust credited Manhattan's account with the proceeds and interest of the two certificates of deposit referred to in Sweeny's letter of August 20, 1962—$5,075,616.44 representing the amount credited with respect to the Belgian American

[8] Paragraph 36 is silent as to the payee of the Irving Trust certificates. However, since paragraph 39 alleges that Irving Trust certified to the State Insurance Department that it was indebted to Manhattan in the amount of $5,500,000 as evidenced by certificates of deposit, and since the alleged scheme of concealing the diminution of assets would not be effective unless the certificates were in Manhattan's name, it is a reasonable assumption that they were so issued.

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Trust certificate of $5,000,000 and $515,361.18 representing the proceeds of the First National Bank of Boston certificate of $500,000. (¶37).

At Manhattan's request, Belgian American Trust issued a check in the sum of $5,500,000 to Irving Trust Company and charged Manhattan's account.

Irving Trust Company thereupon drew its own check in favor of Belgian American Banking in the amount of $5,250,000 and charged this amount of $5,250,000 against the credit established by the $5,500,000 check which it had received from Belgian American Trust. The Irving Trust Company check in the amount of $5,250,000 was then applied by Belgian American Banking to the New England Note Corporation loans (of $5,000,000 and $250,000) then due and owing to Belgian American Banking. (¶37).

It is alleged that the exchange of checks between Belgian American Trust and Irving Trust Company and between Irving Trust Company and Belgian American Banking took place at the same time at a meeting held on January 25, 1963 at the office of one (or possibly both) of the Belgian American banks. (¶37).

As a result of these transactions, it now appeared that Manhattan was the payee of a $5,500,000 certificate of deposit (issued by Irving Trust Company) which, however, had been delivered physically to Garvin, Bantel and then undoubtedly used by Garvin, Bantel as security for its loan of $5,500,000 from Marine Midland Bank.[9]

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[9] There are no allegations, however, regarding the pledge or assignment of this certificate as security nor any allegations regarding an assignment or endorsement by Manhattan of the Irving Trust Company certificate of deposit (of $5,500,000) which presumably would be necessary in order to make this certificate acceptable to Marine Midland Bank as security for Garvin, Bantel's loan.

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Manhattan also had approximately $90,000 on deposit in Belgian American Trust representing interest earned by the certificate of deposit and a balance of $250,000 in Irving Trust Company representing the difference between the $5,500,000 check received by Irving Trust Company from Belgian American Trust and the $5,250,000 check issued by Irving Trust Company to Belgian American Banking. There are no allegations respecting interest on the Belgian American Banking-New England Note Corporation loans; and it is likely that Manhattan paid this interest by using the cash balances on deposit in Belgian American Trust and Irving Trust.

Other than these possibilities arising from the interest earned by the certificates of deposit and the interest payable on the loans, the Belgian American banks, as of January 25, 1963, do not figure in any financial transaction.

On April 18, 1963, Belgian American Banking returned to Begole and Sweeny the shares of Manhattan stock which it had received as collateral on the New England Note Corporation loan. (¶38).

Finally, on May 15, 1963, allegedly for the purpose of concealing the diminution of Manhattan's assets, Irving Trust Company certified to the New York State Insurance Department that Manhattan had on deposit at Irving Trust Company $5,500,000, as evidenced by the certificates of deposit (payable to Manhattan) issued by Irving Trust on January 21, 1963. The certification included statements that the certificates of deposit were free of all liens, claims, or incumbrances and were not held as security for any loan. (¶39). These certificates of deposit, as previously noted, had in fact been delivered to Garvin, Bantel.

The net effect of the myriad financial manoeuvres was that an individual (Begole) or a group of individuals

(Begole, Bourne, et al.) obtained control of Manhattan by (1) having Irving Trust Company deliver its $5,000,000 check to Bankers Life (the then sole stockholder of Manhattan), (2) receiving all of Bankers Life's shares of Manhattan, and (3) repaying Irving Trust Company by selling Manhattan's portfolio of United States Government securities and forwarding the proceeds plus some additional cash to Irving Trust Company.

In essence, Manhattan's corporate funds that should have been kept available to meet Manhattan's creditors' and policyholders' claims were thus unlawfully used by Begole for the noncorporate, private purpose of enabling Begole (and those in concert with him) to acquire all of Manhattan's shares.

Since Manhattan, a solvent corporation, was thereby rendered insolvent, the corporation itself was victimized. But, inasmuch as Begole was Manhattan's sole stockholder, the economic injury was to be borne only by Manhattan's creditors and policyholders.

It is impossible to ascertain with any degree of certainty from the face of the complaint who benefitted from the transaction. Bourne, Sweeny, Begole, Garvin or all of them in concert, may have masterminded and gained from the scheme. As previously noted, Bourne, Begole, Garvin, Bantel and Belgian American Banking received various amounts of cash, totalling $225,000, originating out of the $250,000 loan by Belgian American Banking to New England Note Corporation.

Indeed, if Manhattan had a net worth on January 24, 1962 substantially below $5,000,000, Bankers Life may have been the ultimate beneficiary. Resolution of this puzzlement is not required to decide the present motions.

Appendix D

PLAINTIFF'S LEGAL THEORY AND MOVANTS' CHALLENGES

Plaintiff claims that these transactions, when integrated, constitute violations of section 17(a) of the 1933 Act, 15 U.S.C. §77q(a) because all of the defendants, by their respective participation, employed a device, scheme and artifice to defraud Manhattan. The precise applicability of section 17(a) is never articulated in the complaint. Nevertheless, plaintiff's apparent position is that the bootstrap acquisition of control by Begole, Sweeny and Bourne whereby Manhattan's assets rather than outside funds were the source of the purchase price of Manhattan's shares was fraudulent insofar as Manhattan was concerned. Moreover, in order to retain control of Manhattan without disclosing the means of financing the acquisition of the Manhattan shares, defendants, as part of the same scheme, finagled records and executed intricate financial transactions to conceal and suppress the truth.

Bankers Life and the two Belgian American banks have moved to test the legal sufficiency of this theory as applied to the facts alleged in the complaint. More particularly, these defendants seek an order, pursuant to Fed. R. Civ. P. 12(c), (h), granting judgment on the pleadings and dismissing the complaint as to them on the grounds that the Court lacks federal question or diversity jurisdiction; that plaintiff lacks standing to recover damages for violations of section 17(a) of the 1933 Act; and that the complaint fails to state a claim upon which relief can be granted.

In the context of complaints alleging violations of the securities acts, there is no significant distinction between dismissal for lack of jurisdiction and dismissal for failure to state a cause of action. Federal jurisdiction depends on the existence of a federal question, *i.e.*, the violation of a

provision of one of the securities acts. Should the Court determine that the facts alleged do not make out a violation of federal law, and consequently fails to state a claim, the Court, in effect, has also determined that there is no federal question, and thus no jurisdiction. *See Britt* v. *Cyril Bath Co.*, 290 F.Supp. 934 (N.D.Ohio 1968). Therefore, the Court will not attempt, as a matter of formal analysis, to deal separately with these two grounds. Because the same issues of law are raised by both grounds, they will be discussed simultaneously.

The Court initially, however, directs its attention to the question of standing which can be decided without reference to the merits of the claim since this attack on the complaint assumes *arguendo* that it does allege an actual violation of the securities acts and that the Court has jurisdiction.

Who May Recover for Alleged Violations of the Anti-Fraud Provisions of the Securities Acts?

Defendants, in their memoranda, claim that plaintiff may not recover for violations of section 17(a) of the 1933 Act because that section gives rise to a cause of action in a defrauded purchaser only, and that it is obvious from the face of the complaint that Manhattan was not a purchaser of its own stock. At oral argument and in its briefs, plaintiff presents a number of arguments in refutation.

Plaintiff's position is that, for purposes of these motions, it is not limited to section 17(a) of the 1933 Act (the only section explicitly alleged to have been violated) but that it is entitled to have the motions denied if it has standing and if it makes out a claim under *any* federal statute.

Plaintiff then asserts that section 10(b) of the 1934 Act, 15 U.S.C. §78j(b) (1964) and S.E.C. Rule 10b-5 are also material; that the complaint does state a cause of action under that section; and that plaintiff has standing to sue for damages resulting from violations of section 10(b) of the 1934 Act and section 17(a) of the 1933 Act.

The Court is not restricted to the particular legal theory of recovery or jurisdictional basis alleged in the complaint. If the facts are alleged with reasonable clarity so as to give adequate notice of the transaction, and if plaintiff is entitled to recover under any legal theory, the complaint is sufficient. 1A Barron & Holtzoff, Federal Practice and Procedure §276.1 (Wright ed. 1960); 2A J. Moore, Federal Practice ¶8.14 (2d ed. 1968).

Moreover, because the operative language of section 10(b) and Rule 10b-5 is so similar to that of section 17(a) of the 1933 Act, the Court will consider the applicability of these provisions. *See Hoover* v. *Allen*, 241 F.Supp. 213, 226 n.7 (S.D.N.Y. 1965).

Only a defrauded purchaser may recover under section 17(a) of the 1933 Act. The statute provides:

> "It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly—
>
> (1) to employ any device, scheme or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the

statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

This statute was aimed at fraudulent practices by which sellers of securities could defraud or deceive purchasers. The very purpose of the promulgation of Rule 10b-5 under the 1934 Act was to prohibit individuals or companies from buying securities if they engage in fraud in their purchase. The objective of Rule 10b-5 was to make the same prohibitions contained in section 17(a) of the 1933 Act applicable to purchasers as well as to sellers. *See, e.g., Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461, 463 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952); III L. Loss, Securities Regulation at 1423-30 (2d ed. 1961); A. Bromberg, Securities Law: Fraud at 19-20 (1968).

The requirement of being a defrauded purchaser to recover for a violation of section 17(a) has even more recently been upheld. *See, e.g., Schoenbaum* v. *Firstbrook*, 268 F.Supp. 385, 396 (S.D.N.Y. 1967), *aff'd*, 405 F.2d 200 (2d Cir.), *rev'd on other grounds en banc*, 405 F.2d 215 (2d Cir. 1968); *Colonial Realty Corp.* v. *The Curtis Publishing Co.*, CCH Fed. Sec. L. Rep. ¶92, 105 (S.D.N.Y. 1967); *cf. Hoover* v. *Allen*, 241 F.Supp. 213, 223 (S.D.N.Y. 1965).

Rule 10b-5, however, is more expansive than section 17(a) of the 1933 Act. It prohibits fraud or deception by either a purchaser or seller; and its operative language is "in connection with the purchase or sale of any security" as distinguished from the phrase "in the offer or sale of

any securities" which appears in Section 17(a) of the 1933 Act.[10] Nevertheless, the standing requirement appears to differ only in that defrauded sellers as well as purchasers are included in the permissible class of potential plaintiffs.

In *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952), plaintiff sought to prosecute a derivative suit against the former president and major shareholder of the corporation who allegedly had violated section 10(b) and Rule 10b-5 in rejecting, as

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[10] The texts of section 10(b) and Rule 10b-5 are hereafter set forth:

"Section 10. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * * * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest for the protection of investors."

"Rule 10b-5. Employment of Manipulative and Deceptive Devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security."

president, an allegedly favorable merger offer and who then sold his stock to another company at a substantial premium. In affirming the district court's dismissal of the complaint, the court, *inter alia,* held that the action could not be maintained in the corporate name in the absence of an allegation that the plaintiff corporation was either a defrauded purchaser or seller of securities. This holding has been consistently applied. *See, e.g., Chasin* v. *Mencher,* 255 F.Supp. 545, 548 (S.D.N.Y. 1965) and cases there cited.

Plaintiff contends that *Birnbaum* is no longer controlling doctrine. It argues that recent case law (mostly developed by the Second Circuit) has eroded the validity of *Birnbaum* and the limitation of standing to defrauded purchasers or sellers.

The Court rejects plaintiff's reading of recent decisions. Though there have been, literally, dozens of cases raising the issue since *Birnbaum,* not one has permitted a plaintiff who has been held to be other than a "purchaser or seller" (as those terms have been interpreted) to maintain an action for damages under Rule 10b-5.

In *Hooper* v. *Mountain States Securities Corp.,* 282 F.2d 195 (5th Cir. 1960), a case much relied on by plaintiff, the court did permit the trustee in bankruptcy to sue in behalf of a corporation whose stock had been issued, without registration, and then publicly distributed by some of the defendants. Plaintiff alleged a violation of Rule 10b-5 in that the corporation's transfer agent was induced to issue these shares on the basis of fraudulent representations made to the agent by former officers of the bankrupt. The court held that the corporation could maintain its action for the reason that the issuance of stock was a "sale" and since it did not receive full consideration for the valuable shares issued, the corporation was thus a defrauded "seller."

Hooper, thus, manifestly does not indicate the demise of the purchaser-seller requirement.

Hooper did serve as the genesis for a long string of cases that have permitted corporations to sue for damages when they were the victim of a securities fraud. Yet, in every case, the corporation either qualified as a "seller" since it had issued new shares, or as a purchaser when it redeemed shares or purchased treasury stock.

Other cases are also relied upon by plaintiff to support its thesis that the authority of *Birnbaum* has become attenuated. *Ruckle* v. *Roto American Corporation*, 339 F.2d 24 (2d Cir. 1964), upheld the right of a defrauded *issuer* to recover damages because preventing the perpetration of fraud upon an issuer with the consequent distribution of newly issued and watered stock was one of the chief reasons for the enactment of the securities laws. 339 F.2d at 28. Since an "issuer" is a seller (per *Hooper*), this result is not inconsistent with the *Birnbaum* purchaser-seller requirement. And, although *Ruckle* distinguished *Birnbaum* and *Howard* v. *Furst*[11] on the grounds that the corporations in those cases had not sustained injury, it is clear from the rationale for the *Ruckle* decision that the mere existence of corporate injury was not the crucial, decisive factor; the emphasis was on the spread of overvalued securities resulting from the fraud on the corporation.

Nor do the other cases cited by plaintiff support its *Birnbaum* erosion thesis. In *Vine* v. *Beneficial Finance Co.*, 374 F.2d 627 (2d Cir. 1967), the court held that a minority shareholder who, pursuant to a short form statutory merger, was forced either to sell his shares to the surviving corporation or to retain shares in a defunct corporation was

[11] 23 F.2d 790 (2d Cir. 1956), *cert. denied*, 353 U.S. 937 (1957) (shareholders may not sue derivatively for injury growing out of S.E.C. proxy rule violations).

a "seller", though he retained his shares. The court specifically disclaimed any intention to depart from the traditional purchaser-seller requirement and decided that, under the particular circumstances, plaintiff was, as a practical matter, a seller.

In *A.T. Brod & Co.* v. *Perlow*, 375 F.2d 393 (2d Cir. 1967), the court reversed the dismissal of a complaint which charged that defendant had employed a scheme in refusing to pay for securities he had ordered from plaintiff-broker. The court noted, explicitly, that plaintiff in that case was a purchaser and thus there was no need to delve into the question of whether a broader standing requirement should be adopted. 375 F.2d at 397 n. 3.

It is true that *Brod* implicitly criticized *Birnbaum* in the statement: "Nor do we think it sound to dismiss a complaint merely because the alleged scheme does not involve the type of fraud that is 'usually associated with the sale or purchase of securities'. We believe that §10(b) and Rule 10b-5 prohibit *all* fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception." 375 F.2d at 397. The language the Court of Appeals believed too limited is that of *Birnbaum*.

An analysis of the decision in *Birnbaum*, however, discloses that there were at least two distinct reasons for dismissing the complaint[12]—the failure of the allegations to state a cause of action, and the lack of standing in the corporation to recover for violations of the securities laws when the corporation was neither a defrauded purchaser nor defrauded seller. The language quoted by *Brod* was

[12] One commentator has also noted the tendency to confuse the distinct grounds for decision in *Birnbaum* which results from "an uncritical reading of the general language . . ." *See* A. Bromberg, *supra* at 88.1.

the *Birnbaum* court's rationale for dismissal for failure to state a claim; so too, the only issue involved in *Brod* was the question of whether the facts alleged constituted a violation of Rule 10b-5. And thus, while *Brod* must be read as modifying *Birnbaum* on this issue, *Birnbaum's* standing requirements have not been altered.[13]

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[13] Though not cited by plaintiff to this Court, two other cases have been relied on as authority for the *Birnbaum* "erosion" or "demise" theory. *See* Lowenfels, *The Demise of the Birnbaum Doctrine: A New Era For Rule 10b-5*, 54 Va. L. Rev. 268 (1968). In *Symington Wayne Corp.* v. *Dresser Industries, Inc.*, 383 F.2d 840 (2d Cir. 1967), the court denied, on the grounds of failure to prove irreparable harm, an application for an order enjoining a tender offer allegedly steeped in material misrepresentations and omissions. Though the court reached the merits in a suit brought by the corporation being acquired and two of its shareholders, it specifically refrained from deciding the question of standing. 383 F.2d at 842. In *Mutual Shares* v. *Genesco*, 384 F.2d 540 (2d Cir. 1967), the court did decide that one need not be a purchaser or seller in a suit for an injunction, but held, however, that the trial court's dismissal of the damages claim was correct. *See* 384 F.2d at 547. The injunction was against a continuing deceitful manipulation of the market price of publicly-owned stock; and this conduct was held to create a claim under section 10(b) and Rule 10b-5. The Court explicitly stated that the claim for equitable relief required proof of fewer elements than would a claim for damages.

Lowenfels, *supra*, does not distinguish between the two separate grounds for decision in *Birnbaum;* and thus fails to note that *Brod* modifies *Birnbaum* only with respect to the ground based on failure to state a claim.

Weitzen v. *Kearns*, 271 F.Supp. 616, 622 (S.D.N.Y. 1967), and *Entel* v. *Allen*, 270 F.Supp. 60, 69 (S.D.N.Y. 1967)—both decided by the same judge—apparently also came to the conclusion that *Birnbaum* was "seriously challenged, if not overruled" by reading *Brod* as questioning *Birnbaum's* holding with respect to standing as well as the scope of Rule 10b-5. However, in *Greenstein* v. *Paul*, 400 F.2d 580 (2d Cir. 1968), the Second Circuit squarely reaffirmed the continuing validity of *Birnbaum* as authority for the rule that to maintain an action for damages under section 10(b) and Rule 10b-5 the plaintiff must have been a seller of the stock involved. *See also Christophides* v. *Porco*, 289 F.Supp. 403 (S.D. N.Y. 1968); *Bound Brook Water Co.* v. *Jaffe*, 284 F.Sup. 702 (D.N.J. 1968).

Indeed, in *Greenstein* v. *Paul*, 400 F.2d 580 (2d Cir. 1968), the Court of Appeals appeared to foreclose any argument respecting the demise of the *Birnbaum* purchaser-seller requirement:

> "It has long been the rule in this circuit that to maintain an action under §10(b) of the [1934] Act and Rule 10b-5 of the Securities and Exchange Commission the plaintiff must have been a seller of the stock involved. Birnbaum v. Newport Steel Corp., 193 F.2d 461 (C.A. 2, 1952), cert. denied 343 U.S. 956 (1952). Although criticized, Entel v. Allen, 270 F.Supp. 60, 70 (S.D.N.Y., 1967), it is still the rule at least insofar as actions for damages are concerned. Mutual Shares Corp. v. Genesco, Inc., supra."

EXPANSION OF THE PURCHASER-SELLER REQUIREMENT?

Plaintiff argues that, even if the purchaser-seller requirement has not yet been expressly overruled or broadened, the various cases which were cited by plaintiff for that proposition, and discussed by the Court above, at least indicate discontent with the narrow *Birnbaum* rule, forcing the Court of Appeals to choose other means to circumvent its rigors (*e.g.*, interpreting term "seller" broadly). Plaintiff thus appears to ask this Court to broaden, in an explicit fashion, the standing requirements. Plaintiff refers the Court to the brief of the Securities and Exchange Commission as *amicus curiae* in *Vine* v. *Beneficial Finance Co.*, *supra*, where the S.E.C. argued for such an expansion. Plaintiff argues that this step would eliminate unnecessary complexities, distinctions, and incentives to clever scheming and would achieve greater justice in the individual case. Memorandum of Plantiff In Opposition to Motions Pur-

suant to Rules 12(c) and 12(h) Federal Rules of Civil Procedure at 31.

Other reasons have been advanced by commentators for the abandonment of the purchaser-seller prerequisite. *See, e.g.*, Lowenfels, *supra* note 12; Note, *The Purchaser-Seller Rule: An Archaic Tool for Determining Standing Under Rule 10b-5*, 56 Geo. L.J. 1177 (1968).

The rule that this Court is asked to adopt is that anyone who is injured by a violation of the securities acts may sue to recover damages. The Court declines this invitation to expand the traditional standing requirement.

The Court of Appeals has declined to accede to the repeated requests of plaintiffs and *amici curiae* to enlarge the class of potential plaintiffs in actions for damages arising out of violations of Rule 10b-5. In the light of *Greenstein* v. *Paul, supra*, the Court does not discern any imminent doctrinal change by the Court of Appeals. In these circumstances, a district judge may not disregard an established principle of law. Accordingly, the Court rules that only a defrauded purchaser or seller may sue for damages arising from a violation of section 10(b) of the 1934 Act and S.E.C. Rule 10b-5.

Is Plaintiff a Defrauded Purchaser or Seller of Securities?

The complaint charges a violation of the anti-fraud provisions of the 1933 Act in the purchase and sale of the shares of Manhattan stock on January 24, 1962. (¶¶1, 18, 40). The seller of these shares was Bankers Life and the purchaser was Begole. (¶20). From the face of the pleadings, it thus appears that plaintiff—Manhattan—was neither a purchaser nor a seller of the security (shares of Manhattan stock) which was the subject of the alleged fraud.

At oral argument, however, plaintiff's counsel suggested that—in view of the fact that Begole did not furnish any "fresh" consideration for the purchase of the shares and that, ultimately, it was Manhattan's funds which paid for the shares—Manhattan should be considered the purchaser. (Tr. at 30). While it is true that a corporation can be a purchaser of its own stock within the meaning of the securities laws, *see, e.g., O'Neill* v. *Maytag*, 230 F.Supp. 235 (S.D.N.Y.), *aff'd*, 339 F.2d 764 (2d Cir. 1964), a corporation cannot be the purchaser of *all* of its own stock unless the shares were cancelled and a general dissolution occurred. This is so because a corporation cannot maintain its status as a separate or existing entity (or fictional person) without having another entity or individual serve in the capacity of proprietor or owner.

This Court deems, as a matter of law, the fact that plaintiff may have been the ultimate source of funds for the purchase of Manhattan shares (*i.e.*, the proceeds of the sale of Manhattan's portfolio of United States Government securities were received by Irving Trust Company and credited to Manhattan's account, which thereafter was charged with the $5,000,000 check delivered by Irving Trust Company to Bankers Life) insufficient to establish plaintiff as the purchaser of Manhattan shares because it was never intended that plaintiff would take title to those shares. This Court holds that, insofar as section 17(a) of the 1933 Act and section 10(b) of the 1934 Act are concerned, a purchaser of securities is one who was a party to a transaction whereby he was to assume ownership of securities in exchange for valuable consideration. Under this definition, plaintiff fails to achieve the status of purchaser and, consequently, may not assert a cause of action for a violation

of the securities laws with respect to the purchase and sale of the Manhattan shares.

Though the complaint alleges fraud only in the purchase and sale of the Manhattan shares, plaintiff now adopts the new position that, as a purchaser of a certificate of deposit, and as a seller of United States Government securities, plaintiff has standing to sue in this action (Tr. at 32-35).

Without commenting on the propriety of ruling on the sufficiency of a complaint based on amendatory allegations presented in open court and not formally set forth in the complaint, the Court concludes that if, within the meaning of the securities acts, fraudulent schemes were employed in connection with the sale of Manhattan's portfolio of United States Government securities, plaintiff, *if damaged,* may maintain a suit to recover. Manhattan was a seller of those securities, though management perhaps breached its duties to the corporation in authorizing or ratifying the sale; and, if the corporation was damaged through fraudulent activities, plaintiff may recover damages.

With respect to plaintiff's standing deriving from its alleged "purchase" of various certificates of deposit,[14] the Court is convinced that plaintiff was not a purchaser, despite the fact that it tendered to Belgian American Trust, Irving Trust Company's check for $5,000,000 and received a $5,000,000 certificate of deposit payable to itself. Since, by prearrangement, this certificate was endorsed to New England Note Corporation which delivered it to Belgian

[14] The Court's discussion of purchases of certificates of deposit does not refer to the $500,000 First National Bank of Boston certificate of deposit, regarding which the complaint is generally devoid of information. From the facts alleged, it does not appear that any fraudulent act was practiced relative to this certificate, and thus the question of standing is irrelevant.

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American Banking as collateral for the $5,000,000 loan from Belgian American Banking to New England Note Corporation, and the proceeds of this loan were given directly to Irving Trust Company in payment for the $5,000,000 check that had paid for the certificate of deposit, this entire transaction was a "wash" and had no economic reality. As such, Manhattan was not a "purchaser" of a "security" but was merely participating as a conduit for the sole purpose of having its name appear as payee which enabled the fraud to become further camouflaged.

The Court is mindful of the argument that Manhattan's portfolio of United States Government securities was the ultimate source of funds for financing all the transactions in the three certificates of deposit and that the misappropriation of the proceeds of the sale of Manhattan's portfolio constituted the fraud. What is of controlling importance is that the facts as pleaded do not portray Manhattan as the purchaser of the two Belgian American Trust certificates of deposit. Neither Manhattan's portfolio nor the proceeds thereof was the immediate consideration for the issuance of these two certificates.

Nor was Manhattan a purchaser of the third certificate of deposit,—the Irving Trust Company $5,500,000 certificate of deposit which was paid for by the proceeds of the Marine Midland $5,500,000 loan to Garvin, Bantel. Garvin, Bantel and Irving Trust Company were the only parties to the transaction whereby this certificate was issued, although Manhattan was the payee of the certificate. Garvin, Bantel, as previously noted, received physical delivery of the certificate and presumably used this certificate of deposit as collateral for the $5,500,000 loan which initially furnished the consideration for the issuance of the certificate.

Therefore, the Court need not reach the novel and difficult question of whether certificates of deposit of this nature fall within the statutory definition of the term "security".[14a]

[14a] Section 2(1) of the 1933 Act, 15 U.S.C. §77b(1) (1964), defines the term "security" for the purpose of that act to include "any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a 'security', or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing."

Section 3(a)(10) of the 1934 Act, 15 U.S.C. §78c(a)(10) (1964), sets forth the meaning of the term "security" for the purpose of that act:

> "The term 'security' means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a 'security'; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited."

The certificates of deposit in this case were not issued for a security—they were issued for cash and are pieces of paper "evidencing the existence of a time deposit." *S.E.C.* v. *Fifth Avenue Coach Lines, Inc.*, 289 F.Supp. 3, 31 (S.D.N.Y. 1968). Thus, they would not be deemed "securities" as a species of the class of instruments designated in the statute as "certificate of deposit for a security."

The S.E.C., however, has taken the position that the anti-fraud provisions of the securities acts apply to deposit and share ac-

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Does the Complaint Allege Facts Constituting A Violation of the Securities Acts?

The Court has expressed its conclusion that plaintiff lacks standing to maintain an action for fraud in connection with the purchase or sale of the Manhattan shares and the three certificates of deposit. Were the Court to follow the consequences of this legal conclusion as to standing, it would be unnecessary for the Court to decide the question of whether the acts charged in the complaint with respect to these particular transactions constitute violations of section 17(a) of the 1933 Act and section 10(b) of the 1934 Act.

However, as the Court has also concluded, plaintiff does have standing to maintain an action alleging fraud in connection with the sale of Manhattan's portfolio of United

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counts in national banks. *See* 31 Fed. Reg. 16, 581, *reprinted in* CCH Fed. Sec. L. Rep. ¶77,421 (1966-67 Transfer Binder).

The Supreme Court, in *Tcherepnin* v. *Knight*, 389 U.S. 332 (1967), held that withdrawable capital shares in a state-chartered savings and loan association were "investment contracts" and, consequently, constituted "securities" under the 1934 Act. The Court noted that the term "security" " 'embodies a flexible rather than static principle . . .' " 389 U.S. at 338.

Giving the definition of "security" this liberal reading, a certificate of deposit issued for cash by a bank could be considered the equivalent of an "evidence of indebtedness" and would be a "security" within the meaning of the 1933 Act.

The 1934 Act, however, does not include the term "evidence of indebtedness" in the statutory definition. Conceivably, a certificate of deposit issued for cash by a bank might be deemed an "investment contract" or more likely a "note". But the specific exclusion of "any note, draft, bill of exchange, or banker's acceptance" having a maturity of nine months or less from the definition under the 1934 Act, would appear applicable to a six-months' certificate of deposit issued for cash by a bank and which evidences a time deposit made at the issuing bank.

States Goverment securities. Consequently, the Court must consider whether the acts charged in the complaint constitute violations of section 17(a) of the 1933 Act and section 10(b) of the 1934 Act with respect to that particular security transaction.

Plaintiff contends that there was but one pervasive fraudulent scheme, and that all of the various security transactions and other financial manoeuvres were interrelated and cumulative. Since the Court must, for present purposes, accept the allegations of the complaint as true, the Court will determine whether the complaint, considered as a whole, charges conduct which violates section 17(a) of the 1933 Act or section 10(b) of the 1934 Act. Therefore, the Court's discussion will be directed to the complaint as a whole and be general in terms. The Court holds that the allegations of fraud in connection with the sale of Manhattan's portfolio of United States Government securities do not charge conduct violative of the securities acts. The rationale underlying that holding applies equally to the allegations of fraud in connection with the purchase and sale of the Manhattan shares, that is, such allegations do not charge conduct violative of the securities acts. Similarly, if it be assumed that the three certificates of deposit herein constitute "securities" within the meaning of the securities acts, such rationale demonstrates that the allegations of fraud in connection with the purchase of said certificates of deposit do not charge conduct violative of the securities acts.

The gravamen of the complaint is the diminution in Manhattan's assets. This diversion or misappropriation of assets apparently was the essence of the fraud. The allegations describing subsequent conduct charge only that they were designed to conceal the defendants' misdeeds in a maze of numerous intricate and confusing transactions.

Appendix D

A viable claim under Rule 10b-5[15] requires that there have been fraud or deception in connection with the purchase or sale of securities. In interpreting the phrase "in connection with the purchase or sale of any security," it would be relevant to discuss the purpose of the Congressional enactment, and, in so doing, to consider whether the alleged fraud could result in the abuses sought to be curbed or prevented and whether the fraudulent activity otherwise touched on any federal concern.

The securities acts, and especially the 1934 Act, were intended to prevent fraud and deception, manipulation and inadequate disclosure in the dissemination and trading of securities. The securities acts are not so much concerned with fraud *per se* as with the effect of fraud upon investors and the public interest in maintaining free and open securities markets. 1934 Act §2(3), 15 U.S.C. §78b(3); *Schoenbaum* v. *Firstbrook,* 405 F.2d 200, 212 (2d Cir.), *rev'd en banc,* 405 F.2d 215 (2d Cir. 1968); *S.E.C.* v. *Texas Gulf Sulphur Co.,* 401 F.2d 833, 858-60 (2d Cir., *en banc,* 1968); *cf. A.T. Brod & Co.* v. *Perlow, supra.*

In order to sustain a complaint alleging fraud under section 10(b) of the 1934 Act, it must appear with reasonable clarity from the face of the complaint either (1) that a purchase or sale of securities is at the crux of a fraudulent scheme; or (2) that inducing a purchase or sale of securities is the object of a fraudulent scheme; or (3) that fraudulent statements, misstatements, or omissions are made in a manner which is reasonably calculated to in-

[15] On the premise that the more liberal language of Rule 10b-5 is an indication that its scope is more expansive than that of section 17(a) of the 1933 Act, the Court will discuss this issue only in terms of Rule 10b-5. If no claim is established under Rule 10b-5, *a fortiori,* none would exist under section 17(a) of the 1933 Act.

fluence the investing public, or are of the sort which the reasonable investing public might rely upon; or (4) that the trading process is abused through potential market manipulation or the spread of watered stock.

The purity of the security transaction and the purity of the trading process are the sole objectives of federal concern. Therefore, the consummation of a security transaction as a mere incident of a fraudulent scheme and the mere fact of injury caused by the fraud, in the absence of any possibility that the fraud might materially affect the purity of the security transaction and the purity of the trading process would not make the fraud federally cognizable. *Cf. O'Neill* v. *Maytag*, 230 F.Supp. 235, 239 (S.D. N.Y.), *aff'd*, 339 F.2d 764 (2d Cir. 1964).

Giving the unique factual allegations of the complaint a most liberal reading, the Court concludes that plaintiff was not the victim of "federal fraud" as defined above.[16] A

[16] The Court also declines to sustain the sufficiency of the complaint because the injury in this particular case (and thus the benefit of any recovery) was not incurred by anyone who was the subject of federal concern. In view of the unusual fact that the fraud was practiced not upon any member of the "decision-making body" of the corporation (*i.e.*, officers, directors, or shareholders), *see Globus, Inc.* v. *Jaroff*, 266 F.Supp. 524, 529 (S.D.N.Y. 1967); *Simon* v. *New Haven Board & Carton Co.*, 250 F.Supp. 297, 299 (D. Conn. 1966), but only upon creditors and policy holders, it is dubious whether plaintiff corporation was ever defrauded or deceived.

Doubtless, a corporation may be deceived or defrauded even if every member of the board of directors was fully informed of the true facts (or, in factual situations similar to this case, that all of the directors were participants in the scheme). *Schoenbaum* v. *Firstbrook*, 405 F.2d 215 (2d Cir. *en banc*, 1968); *Continental Bank & Trust Co.* v. *Garfinkle*, 292 F.Supp. 709 (S.D.N.Y. 1968). But, as is evident from Judge Hays' dissenting opinion in the three-judge panel decision in *Schoenbaum* v. *Firstbrook*, *supra* (Judge Hays, significantly, having also authored the *en banc* majority opinion reversing the three-judge panel's decision), in

federal claim is not pleaded by allegations that, in the course of a scheme to loot a corporation of its assets, certain security transactions occurred, when these transactions—though contaminated by the overriding evil intent to accomplish the ultimate looting—did not involve fraud or deceit in connection with the sale or purchase of a security.

Manifestly, the sale of Manhattan's portfolio and the purchase of the Manhattan shares were necessary steps toward the ultimate looting of Manhattan's assets. But Rule 10b-5 requires the employment of fraud in connection with a security transaction, which is essentially different from the effectuation of a security transaction in connection with a fraudulent activity.[16a]

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such a case, there must be a showing that the directors deceived the shareholders—"the real owners of the property with which the directors were dealing." 405 F.2d at 215.

The highly individualized circumstance present in the case at bar—the lack of injury to shareholders—intensifies the Court's reluctance to hold that the complaint states a claim of federal fraud.

[16a] The distinction here drawn can be best illustrated by analogy to the general conspiracy statute, 18 U.S.C. §371 (1964), which makes unlawful a conspiracy when one or more of the members of the conspiracy "do any act to effect the object of the conspiracy." In order for conduct to qualify as an overt act under that statute, the conduct need not, of itself, be unlawful, provided it was done to effect the object of the conspiracy. Nevertheless, unless the act done in furtherance of the conspiracy was itself unlawful, although committed for the purpose of furthering the object of the conspiracy, the overt act may not serve as the basis for a criminal prosecution for a substantive crime.

Similarly, in this case, the various security transactions were overt acts committed for the purpose of promoting and effecting the object of the fraudulent conspiracy (*e.g.*, the sale of Manhattan's portfolio of United States Government securities was necessary to effectuate the looting of Manhattan's assets). However, unless such security transactions were independently unlawful—

Appendix D

The complaint, taken as a whole, alleges no more than a common law action for misappropriation of corporate funds by a fiduciary, embezzlement or fraudulent conveyance perhaps, or the distribution of an illegal dividend. None of these actions, in the absence of diversity of citizenship, can be maintained in a federal court.

Ruckle v. *Roto American Corp.*, 339 F.2d 24 (2d Cir. 1964) and *Schoenbaum* v. *Firstbrook*, 405 F.2d 215 (2d Cir., *en banc*, 1968) do not hold otherwise. In *Ruckle*, the corporation proposed to issue its own shares to the president for a less than adequate consideration. A majority of the board withheld material information from one of the directors before approval was voted. The court held that the issuance would constitute a violation of Rule 10b-5.

In *Schoenbaum*, the court held that the issuance of stock by a corporation to its controlling stockholder at "vastly inadequate prices," apparently with each board member having full knowledge of the inadequacies (all were named as co-conspirators and defendants), stated a claim for relief under section 10(b) and Rule 10b-5.

The crucial facts in these cases were that, in each, the "fraudulent practice" was deception (whether of directors or shareholders) which directly resulted in the issuance of stock for inadequate consideration, thus, creating the danger of the spread of "thin" or "watered" stock. The direct involvement of the deceit with a transaction of securities

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i.e., unless there was fraud in connection with the purchase or sale of a security—they could not serve as the basis for a substantive claim under section 10(b) and Rule 10b-5. As pleaded, the security transactions themselves, when considered from the viewpoint of section 10(b) and Rule 10b-5, were innocuous though constituting overt acts furthering the fraudulent scheme. Consequently, they cannot serve as the independent predicate for liability under section 10(b) and Rule 10b-5.

is fraud "in connection with" the sale of stock, and, consequently, constitutes federal fraud irrespective of whether it also constitutes corporate mismanagement. As the three-judge panel in *Schoenbaum* v. *Firstbrook, supra,* stated: "A fraud upon a corporation which has the effect of depriving it of fair consideration for the issuance of its stock would necessarily have the effect of reducing the equity of the corporation's shareholders and this reduction in equity would be reflected in lower prices bid for the shares on the domestic stock market." 405 F.2d at 208.

The facts in the instant case, on the contrary, could not give rise to any of these dangers and do not evidence that the fraud was rooted in a security transaction.

That the complaint in this case states no more than a non-federal common law cause of action becomes even more evident upon consideration of the factual situation and language of the Court of Appeals in *Mutual Shares Corp.* v. *Genesco, Inc.,* 384 F.2d 540 (2d Cir. 1967). Plaintiffs there alleged, *inter alia,* that defendant Genesco, a 94% stockholder in S.H. Kress & Co. had acquired its shares pursuant to a fraudulent conspiracy, the purpose of which was to finance its purchases of Kress stock from Kress' own assets and to manage Kress for Genesco's own benefit, appropriating Kress' assets in the meanwhile. After holding that plaintiffs could not maintain an action charging violations of Rule 10b-5 occurring before plaintiffs had acquired their shares, the court stated (as to the period subsequent to plaintiffs' acquisition of shareholder status) that the "fraudulent activities then alleged are primarily corporate abuse and diversion, claims cognizable under state law but not under the Act." 384 F.2d at 546. Only the claim that defendants had "manipulated the market price

of Kress stock, keeping dividends to a minimum, in order to force minority shareholders to sell out to Genesco at depressed values," *id.*, stated a good cause of action under Rule 10b-5.

The complaint in this case also fails to allege any actual or potential abuse of the trading process. Since public distributon of watered or valueless stock was not a part of the scheme, and the fraud had no potential manipulative effect on the market, and did not raise the spectre of any other evil which prompted passage of the securities acts or is a subject of federal concern, the factual situation in the instant case differs significantly from those in the cases plaintiff cites as major support for sustaining the validity of its claim.

A.T. Brod & Co. v. *Perlow; supra,* explicitly found that the fraud was federally cognizable because it had a "potentially manipulative effect on the securities market." 375 F.2nd at 397.

Hooper v. *Mountain State Securities Corp.*, 282 F.2d 195 (5th Cir. 1960), *cert. denied,* 365 U.S. 814 (1961), is also stressed heavily by plaintiff. In that case, an individual named Cage was required to sever his connection with the plaintiff corporation (the nominal plaintiff was the corporation's trustee in bankruptcy) when a new group acquired control. Cage concocted a scheme whereby he induced the plaintiff's transfer agent to issue new shares with a market value of about $700,000 after transferring to the corporation worthless contract rights. The actual fraud appeared to be the false representations made to the transfer agent by certain former officers of the corporation and the phony corporate documents prepared to justify and legitimize the issuance of stock. The scheme also involved

the distribution by Cage and his cohorts of this newly issued stock over security markets to unwary members of the investing public. Because the purpose and object of the scheme were to have valuable corporate stock issued to Cage (actually to another corporation controlled by Cage which was liquidated immediately after receiving the stock) in exchange for worthless consideration, and then to distribute the stock publicly, the fraud was definitely "in connection with" the purchase and sale of securities. The scheme induced an unfair sale of securities and it had as a major purpose the spread of watered stock to many investors.

In *Pettit* v. *The American Stock Exchange,* 217 F.Supp. 21 (S.D.N.Y. 1963), a similar scheme was perpetrated when huge amounts of Swan-Finch stock was issued, through various corporate shells, for worthless consideration, and then distributed over the American Stock Exchange. That court noted that the fraud violated Rule 10b-5 because the transaction represented an "abuse of the securities trading process," and because the "heart of this case are two fraudulent transactions in securities." 217 F.Supp. at 25-26.

Each security transaction herein was effected for full and fair consideration with full knowledge in both purchaser and seller as to the value of the securities sold. Where this has occurred Rule 10b-5 is not violated. *See* Fleischer, *"Federal Corporation Law": An Assessment,* 78 Harv. L. Rev. 1146, 1166 (1965). Only where the security transaction was a "vital aspect of a continuing scheme," should the fact of subsequent misappropriation of the consideration result in a violation of Rule 10b-5. *Compare Cooper* v. *North Jersey Trust Co.,* 226 F.Supp. 972, 978 (S.D.N.Y. 1964), *with S.E.C.* v. *Fifth Avenue Coach Lines, Inc.,* 289 F.Supp. 3, 36-39 (S.D.N.Y. 1968).

Appendix D

The complaint in this case presents no more than a complicated scheme of common law fraud.[17]

Discovery herein has been extensive. The parties have not called to the Court's attention any facts which were not alleged in the complaint and which would, if leave to amend the complaint were granted, state a cause of action under the securities acts. Accordingly, the Court hereby dismisses the complaint as to the movants and hereby directs that judgment be entered for movants. Fed. R. Civ. P. 54(b).

Dated: New York, N. Y.
June 3, 1969.

/s/ WILLIAM B. HERLANDS
William B. Herlands
U.S.D.J.

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[17] Plaintiff instituted such a common law action in New York County, Supreme Court in 1965. After joinder of issue, further proceedings in the action were enjoined. The factual allegations of the complaint filed in the state court proceeding are essentially the same as those contained in the complaint herein.

APPENDIX E

UNITED STATES DISTRICT COURT

FOR THE SOUTHERN DISTRICT OF NEW YORK

63 Civ. 3490—June 9, 1969

SUPERINTENDENT OF INSURANCE OF THE STATE OF NEW YORK, as Liquidator of Manhattan Casualty Company,

Plaintiff,

v.

BANKERS LIFE AND CASUALTY COMPANY, Irving Trust Company, Belgian American Banking Corporation, Belgian American Bank & Trust Company, Garvin, Bantel & Company, New England Note Corporation, George K. Garvin, John F. Sweeny, the Estate of Standish T. Bourne, by Standish T. Bourne, Jr., as Executor, the Estate of James F. Begole, by Patricia C. R. Begole, Executrix,

Defendants.

RYAN, District Judge:

Jurisdiction of the Court to entertain this action is now directly challenged in motions to dismiss made by defendant IRVING TRUST COMPANY and by defendants GARVIN, BANTEL & COMPANY and GEORGE K. GARVIN. (See our memorandum endorsement of June 19, 1968.)

Diversity jurisdiction is not present.

Plaintiff urges that, although the complaint alleges that jurisdiction over the subject matter is based on violations of Section 17A of the Securities Exchange Act of 1933 (15

.U.S.C. 77q(a)), jurisdiction also exists under Section 10(b) of the 1934 Act and S.E.C. Rule 10b-5.

Plaintiff was neither a defrauded purchaser nor seller, and he may not plead a claim under Section 10(b) of the 1934 Act and S.E.C. Rule 10b-5. Judge Herlands so held granting the Bankers Life motion to dismiss for lack of jurisdiction (See Judge Herlands' opinion of June 3, 1969). I agree.

The complaint does allege fraud in connection with the sale of Manhattan's U.S. Government securities. The fraud charges was not in violation of the Securities Acts of either 1933 or 1934. The fraud alleged was not in the purchase or sale of securities, but was waste of Manhattan's assets by diversion and misappropriation of its securities. I agree with Judge Herlands that "the complaint in this case presents no more than a complicated scheme of common law fraud" over which there is no independent federal jurisdiction.

Motions to dismiss are granted without prejudice to prosecution of the action plaintiff filed and is pending in the Supreme Court, County of New York. Settle appropriate order directing entry of such judgment.

Dated: June 9, 1969.

/s/ SYLVESTER J. RYAN
Sylvester J. Ryan
U.S.D.J.

SUPREME COURT, U. S.

Supreme Court, U.S.
FILED
FEB 19 1971
E. ROBERT SEAVER, CLERK

IN THE

Supreme Court of the United States

October Term, 1970

No. ~~1159~~ 70-60

SUPERINTENDENT OF INSURANCE OF THE STATE OF NEW YORK, as Liquidator of MANHATTAN CASUALTY COMPANY,

Petitioner,

against

BANKERS LIFE AND CASUALTY COMPANY, IRVING TRUST COMPANY, BELGIAN AMERICAN BANKING CORPORATION, BELGIAN AMERICAN BANK & TRUST COMPANY, GARVIN, BANTEL & COMPANY, GEORGE K. GARVIN,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

RESPONDENTS' BRIEF IN OPPOSITION

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IN THE

Supreme Court of the United States

October Term, 1970

No. 1159

SUPERINTENDENT OF INSURANCE OF THE STATE OF NEW YORK, as Liquidator of MANHATTAN CASUALTY COMPANY,
Petitioner,

against

BANKERS LIFE AND CASUALTY COMPANY, IRVING TRUST COMPANY, BELGIAN AMERICAN BANKING CORPORATION, BELGIAN AMERICAN BANK & TRUST COMPANY, GARVIN, BANTEL & COMPANY, GEORGE K. GARVIN,
Respondents.

RESPONDENTS' BRIEF IN OPPOSITION

Preliminary Statement

This brief is submitted in opposition to the petition for a writ of certiorari to the United States Court of Appeals for the Second Circuit seeking review of the judgment of that Court which affirmed judgments of the United States District Court for the Southern District of New York dismissing the complaint for lack of subject matter jurisdiction.

Questions Presented

None of the five numbered questions set forth in the Petition justifies review by this Court of the decision below. Questions "1," "2" and "5" concern no more than peti-

tioner's mistaken contention that conduct allegedly constituting corporate waste and mismanagement is a violation of the federal securities acts merely because certain securities transactions occurred incidental thereto. Question "4" seeks abolition of the purchaser-seller requirement first enunciated in *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied,* 343 U.S. 956 (1952), though its abolition would not affect the result reached by the court below. Question "3" asserts a conflict between two Circuits which does not exist.

Statement of the Case

Petitioner initiated this action in August 1963 and alleged in his complaint, as the sole jurisdictional basis for the action, "violations of Section 17A of the Securities Act of 1933 (15 U.S.C.A. §77q(a))." Commencing with the respondents' answers to the complaint, and from time to time thereafter, petitioner was put on notice of the lack of federal jurisdiction. In August 1967 petitioner represented that he had completed all of his pretrial discovery by filing the required Note of Issue in which he again stated that "a violation of Section 17(a) of the Securities Act of 1933" was the jurisdictional basis for the action.

The essence of the complaint is that the late James F. Begole, a defendant who was the sole purchaser of all of the outstanding capital stock of Manhattan Casualty Company ("Manhattan"), engaged in a scheme, with others, to deplete and misappropriate assets of Manhattan and to conceal that misappropriation from the Superintendent of Insurance of New York. In 1965, in the midst of pretrial discovery and in apparent recognition of the absence of federal jurisdiction, petitioner commenced an action—still pending—in the Supreme Court of the State of New York against the same defendants, alleging virtually the same facts, and seeking relief under state law identical to the relief sought in this action.

In an order dated June 19, 1968, the District Court (Hon. Sylvester J. Ryan) questioned its jurisdiction over the subject matter of the action and indicated the need for resolution of that issue.* Respondents thereupon moved to dismiss the complaint under Rules 12(c) and 12(h) of the Federal Rules of Civil Procedure on the grounds that the District Court lacked subject matter jurisdiction and that the complaint failed to state a claim under federal law.

On June 3, 1969, the District Court (Hon. William B. Herlands) filed its opinion granting the motions of respondents Bankers Life and Casualty Company, Belgian-American Banking Corporation and Belgian-American Bank & Trust Company. (App. D).** On June 9, 1969, that court (Ryan, J.) filed a second opinion granting similar motions of respondents Irving Trust Company, Garvin, Bantel & Company and George K. Garvin. (App. E). On July 22, 1970, the Court of Appeals for the Second Circuit affirmed the judgments dismissing the complaint. (App. A). Petitioner's motions for rehearing and rehearing *en banc* were denied on September 30, 1970. (App. B and C).

In opposing respondents' jurisdictional motions and in connection with his application for leave to amend the complaint, petitioner resorted to use of the entire record accumulated during the four years of pretrial discovery. For the first time he asserted that federal jurisdiction was based upon Section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. §78j(b)) and Rule 10b-5 promulgated thereunder. Judge Herlands considered the motions to dismiss on the basis of the allegations of the complaint, the additional facts presented in petitioner's brief and petitioner's "amendatory allegations presented in open court."

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* Thereafter, petitioner served a "Preliminary Pre-trial Memorandum" in which he again claimed as the sole basis for federal jurisdiction that "This action is based on Section 17A of the Securities Act of 1933 (15 U.S.C.A. 77q(a))."

** Appendix references are to the appendices to the Petition.

(App. D, p. 44a). After a comprehensive analysis of all of the facts presented by petitioner, Judge Herlands concluded that the "complaint in this case presents no more than a complicated scheme of common law fraud" and held that there was no federal jurisdiction under either the 1933 or 1934 Acts. (See App. D, p. 56a).

Judge Ryan, in granting the motions before him, expressed full agreement with the opinion of Judge Herlands and also found that the "fraud alleged was not in the purchase or sale of securities, but was waste of Manhattan's assets by diversion and misappropriation of its securities." He further agreed "with Judge Herlands that 'the complaint in this case presents no more than a complicated scheme of common law fraud' over which there is no independent federal jurisdiction." (App. E, p. 58a). Judge Ryan expressly stated that the dismissal of the complaint was without prejudice to the prosecution by petitioner of his pending New York Supreme Court action. (App. E, p. 58a).*

Similarly, the Court of Appeals in affirming the judgments of the District Court stated that it did "not decide that the creditors of Manhattan do not have any remedy under general state tort law for the fraud practiced on their debtor, but only that the federal Securities Acts have not provided a federal forum for its enforcement." (App. A, p. 12a).

As the opinions of the courts below and the Petition itself plainly evidence, the facts presented by this case are "highly individualized". (App. D, p. 51a, n.16). For this reason and because, as will hereinafter appear, the grounds upon which the Petition is based do not present any "spe-

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* New York Civil Practice Law and Rules, Rule 3117(c), provides in part: "When an action has been brought in any court of any state or of the United States and another action involving the same subject matter is afterward brought between the same parties or their representatives or successors in interest all depositions taken in the former action may be used in the latter as if taken therein."

cial and important reasons" justifying further review of the questions decided below, it is respectfully submitted that the Petition should be denied.

Reasons For Denying the Petition

I.

Petitioner has failed to state any claim under the Federal Securities Acts.

Petitioner asserts that during the course of certain transactions, which occurred between January 1962 and April 1963, Manhattan was defrauded of certain assets by defendant Begole and others, that those assets were used to finance Begole's acquisition of the outstanding capital stock of Manhattan, and that the misappropriation of Manhattan's assets was concealed in a complex series of transactions. Petitioner contends, in effect, that Begole's self-inflicted fraud as the sole stockholder-purchaser of Manhattan is actionable under the federal securities laws merely because securities transactions occurred incidental to it.

While in his complaint petitioner alleged that the 1933 Act was violated by defendant Begole's purchase of the outstanding Manhattan capital stock, in opposing respondents' jurisdictional motions he reformulated his theory and urged that the alleged misappropriation of Manhattan's assets violated the securities laws because Manhattan's government securities were sold and various certificates of deposit were purchased. (App. D, p. 44a).*

* There is no need for respondents to be drawn into any dispute as to those matters which are set forth as purported facts in the Petition's "Statement of the Case" and which bear little resemblance to the allegations of the complaint or the pretrial discovery record. The Court of Appeals, as the Petition acknowledges (p. 13), in affirming the judgments of the District Court, considered petitioner's version of the facts and concluded that a federal claim had not been stated.

Petitioner has never claimed, and after extensive pretrial discovery is unable to claim, either that the alleged misappropriation of Manhattan's assets resulted in any injury to any shareholder or investor or that any market for any security was manipulated or otherwise abused.

Petitioner's disagreement with the decision of the Court of Appeals is primarily based upon what he characterizes as the "terms of the sale test". (See Petition, pp. 14-16, 18, 21). Petitioner mistakenly contends that the Court of Appeals held the federal securities laws inapplicable by looking only to "the terms of the sale" of the various securities involved. The contention is demonstrably incorrect.

The Court of Appeals held, as did the District Court, that a federal claim had not been stated because the misappropriation of Manhattan's assets was not, in the language of the 1934 Act, a fraud "in connection with the purchase or sale of any security." In interpreting those words the courts below did not confine themselves to any "terms of the sale test", but properly inquired into the scope and purpose of the Congressional enactment. (App. A, pp. 11a-12a; App. D, pp. 49a-50a). As was so clearly stated by the Court of Appeals:

> "The fraud alleged in this case in no way affected either the securities markets or the investing public. No stockholders were defrauded, no investor injured. The purity of the security transaction and the purity of the trading process were unsullied. There was no danger that the securities sold would be overvalued on reaching the public markets." (App. A, p. 11a).

The Court of Appeals went on to state that the civil liabilities provisions of the federal securities acts "were 'part of a broad integrated program designed to obtain honest dealings in securities,' *Wilko* v. *Swan,* 127 F.Supp. 55, 58

(S.D.N.Y. 1955), not one to create an unlimited federal right of action for damages for all who have been defrauded in any area of economic activity." (App. A, pp. 11a-12a).

The acts of corporate waste and mismanagement alleged by petitioner do not constitute wrongs which the federal securities laws were intended to remedy. As the Court of Appeals for the Fifth Circuit recently stated in *Herpich* v. *Wallace,* 430 F.2d 792, 809 (1970):

> "If Congress had intended that the federal courts inquire into every decision affecting the management of corporations and then fashion a new federal law superseding state law on the fiduciary responsibility of corporate directors, officers, and controlling persons, presumably so revolutionary a federal intervention into an area traditionally handled by the states would have been clearly expressed."

II.

The decision of the Second Circuit is not in conflict with the decision of the Fifth Circuit in *Hooper* v. *Mountain States Securities Corp.*

Petitioner claims that the decision of the Court of Appeals for the Fifth Circuit in *Hooper* v. *Mountain States Securities Corp.,* 282 F.2d 195 (5th Cir. 1960), *cert. denied,* 365 U.S. 814 (1961), which also decided *Herpich* v. *Wallace, supra,* conflicts with the decision of the Court of Appeals for the Second Circuit in this case. In so arguing, however, petitioner ignores the fact that in *Hooper* the Court of Appeals found the relationship, absent in this case, which must exist between an alleged fraud and a securities transaction for a federal claim to be stated.

In *Hooper,* a trustee in bankruptcy was permitted to maintain an action on behalf of a corporation whose stock had been issued and, without registration, distributed to the public. It was held that the plaintiff sufficiently alleged a violation of federal law because the transfer agent for the corporation was induced, by fraudulent representations of the officers of the corporation, to issue stock of the corporation for inadequate consideration, so that the corporation was found to be a defrauded "seller" of that stock. As Judge Herlands, in examining *Hooper,* stated below:

> "Because the purpose and object of the scheme were to have valuable corporate stock issued . . . in exchange for worthless consideration, and then to distribute the stock publicly, the fraud was definitely 'in connection with' the purchase and sale of securities. The scheme induced an unfair sale of securities and it had as a major purpose the spread of watered stock to many investors." (App. D, p. 55a).

Petitioner has never contended that any comparable wrongdoing occurred in this case. Analyzing petitioner's version of the facts and the relevant statutory provisions, the courts below found that no federal claim could be asserted because, unlike *Hooper,* this case involves no manipulation or other abuse of any securities market or the trading process, no impurity of any security transaction, and no possibility of any injury to shareholders or the investing public.

Accordingly, the decision of the Court of Appeals for the Second Circuit herein is fully consistent, and not in conflict, with the decision of the Court of Appeals for the Fifth Circuit in *Hooper.*

III.

The purchaser-seller requirement of *Birnbaum* v. *Newport Steel Corp.* should not be reviewed on the record in this case.

The courts below held that petitioner, suing on behalf of Manhattan, had no standing to assert any federal claim with respect to the sale of the Manhattan capital stock since Manhattan was neither a purchaser nor a seller of those securities. *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952). *Birnbaum* held that only a defrauded purchaser or seller could maintain a private damage action under Section 10(b) of the 1934 Act for alleged fraud "in connection with the purchase or sale of any security." That holding has been uniformly and repeatedly followed by every Circuit considering the issue. See *Greenstein* v. *Paul*, 400 F.2d 580 (2d Cir. 1968); *Herpich* v. *Wallace*, 430 F.2d 792 (5th Cir. 1970); *Mader* v. *Armel*, 402 F.2d 158 (6th Cir. 1968), *cert. denied sub nom. Young* v. *Mader*, 394 U.S. 930 (1969); *Dasho* v. *Susquehanna Corp.*, 380 F.2d 262 (7th Cir.), *cert. denied sub nom. Bard* v. *Dasho*, 389 U.S. 977 (1967); *The Greater Iowa Corp.* v. *McLendon*, 378 F.2d 783 (8th Cir. 1967); and *Erling* v. *Powell*, 429 F.2d 795 (8th Cir. 1970).

Only one year ago, the Court of Appeals for the Second Circuit reaffirmed the purchaser-seller requirement. *Iroquois Industries, Inc.* v. *Syracuse China Corp.*, 417 F.2d 963 (2d Cir. 1969), *cert. denied*, 399 U.S. 909 (1970). The court, in that case, stated:

> "The *Birnbaum* rule recognizes the policy of Congress in enacting Section 10(b) and of the Commission in adopting Rule 10b-5, namely, the protection of defrauded purchasers and sellers. It is not the province of the courts to extend Section 10(b) to apply

to transactions not intended to be covered by Congress. We do well to heed the words of Mr. Justice Black, writing for the Court in a case about another section of the 1934 Act, *Blau* v. *Lehman*, 368 U.S. 403, 413, 82 S. Ct. 451, 457, 7 L. Ed. 2d 403 (1962):

> 'Congress can and might amend [the Act] if the Commission would present to it the policy arguments it has presented to us, but we think that Congress is the proper agency to change an interpretation of the Act unbroken since its passage, if the change is to be made.'" 417 F.2d at 969.

Petitioner nevertheless asserts that the long-standing purchaser-seller requirement should be abolished. He argues that the holding that he has no standing to assert a federal claim with respect to the sale of the Manhattan capital stock presents to this Court the question of whether that requirement should be eliminated. However, review of that requirement by this Court is not merited on the record in this case because the decisions of the courts below would not be changed even if the purchaser-seller requirement were abolished.

The courts below held that petitioner did have standing to assert a federal claim with respect to the sale of Manhattan's Government securities. Nevertheless, the courts concluded that petitioner was unable to plead a federal claim. (App. D, pp. 44a, 47a-48a; see App. A, p. 9a). The reasoning of the courts below (see Point I *supra*) in concluding that petitioner could not plead a federal claim applies not only to the sale of Manhattan's Government securities and the purchase of certificates of deposit but also to the sale of the Manhattan capital stock. In fact the District Court explicitly held that, assuming petitioner's standing to assert a federal claim with respect to the sale of Manhattan's stock, no federal claim could be stated on behalf of Manhattan with respect to the sale of those securities. (App. D, p. 48a) The reasoning of the Court of Appeals compels the same result.

Any standing to sue which might be afforded petitioner by abolition of the *Birnbaum* rule would not cure the jurisdictional deficiency of the complaint, because petitioner would still have nothing more than a claim based upon an alleged misappropriation and waste of corporate assets to which certain securities transactions were incidental. As the District Court observed in *Pettit* v. *American Stock Exchange*, 217 F.Supp 21, 25 (S.D.N.Y. 1963):

> "[C]ourts have been disinclined to allow 'innumerable facets of internal corporate affairs' to be included within federal question jurisdiction on the basis of a purchase or sale of securities that is only incidental to a major mismanagement issue."

Since the outcome of this case cannot be affected by the abolition of the purchaser-seller requirement, it is respectfully submitted that this is not a proper case for its review.

Conclusion

The Petition is devoted in large part to a restatement of the purported facts of this case and to a renewed effort by petitioner to discover a formulation of those facts which may create a suggestion of federal jurisdiction. Notwithstanding the effort made, the Petition describes no more than a claim of misappropriation of corporate assets and corporate waste. Such a claim does not provide a basis for federal relief.

Petitioner's contention that a conflict exists between the decision of the Second Circuit in this case and the decision of the Fifth Circuit in *Hooper* is erroneous. Even a cursory review of *Hooper* indicates that the facts present in that case were a paradigm of the evils which Congress sought to prevent by enacting the federal securities laws. In contrast, as the courts below indicated, the facts alleged here present no more than a common law fraud not cognizable under the federal securities laws.

The argument that the purchaser-seller requirement should be set aside has uniformly been rejected. In any

event, that requirement should not be reviewed in this case, the outcome of which cannot be affected by its abolition.

Finally, the issues presented in this case have been carefully examined and correctly determined by the courts below and do not present a suitable occasion for this Court to exercise its discretion to review them.

The Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit should be denied.

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February 19, 1971

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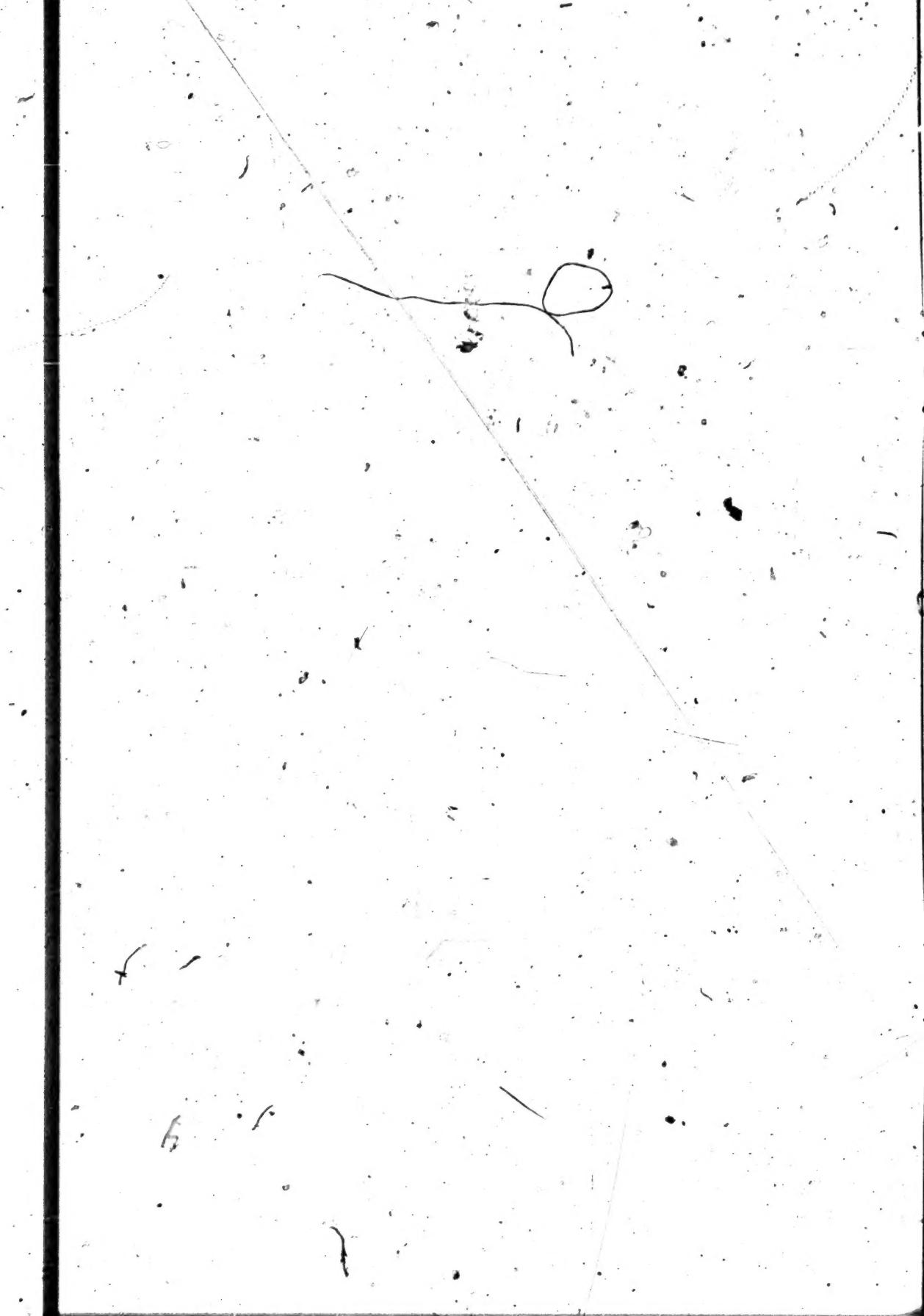
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In the Supreme Court of the United States

OCTOBER TERM, 1970

No. 1159

SUPERINTENDENT OF INSURANCE OF THE STATE OF NEW YORK, AS LIQUIDATOR OF MANHATTAN CASUALTY COMPANY, PETITIONER

v.

BANKERS LIFE AND CASUALTY COMPANY, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION AS AMICUS CURIAE IN SUPPORT OF THE PETITION FOR A WRIT OF CERTIORARI

The Solicitor General, on behalf of the Securities and Exchange Commission, is filing this brief *amicus curiae* because this case presents an important question in the administration of the Securities Exchange Act of 1934 which this Court should review. [1]

[1] While we recognize that this brief is not timely filed under this Court's Rules, it has not been possible to file it at an earlier date and we believe the importance of the question nonetheless warrants the expression of the Commission's views. We note that the parties will not be prejudiced by the resulting delay. Even allowing a reasonable time for response, it is evident that consideration of the petition will be had during the present term of

QUESTION PRESENTED

The Commission will discuss the following question: Whether Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b–5 thereunder provide a remedy for an agent's fraudulent inducement of a security holder to sell his securities through the agent on the misrepresentation that the agent will return the proceeds of the sale to the security holder.

STATEMENT

The petition seeks review of a decision of the court of appeals which affirmed orders dismissing the complaint for failure to state a cause of action under the federal securities laws. This is an action brought by the Superintendent of Insurance of the State of New York, as Liquidator of Manhattan Casualty Company ("Manhattan"). Manhattan was a New York corporation engaged in the casualty insurance business and was wholly owned by, but under management separate from, defendant Bankers Life and Casualty Company ("Bankers Life") (Pet. App. 19a). The complaint alleges generally that each of the defendants was a participant in a scheme to defraud Manhattan in connection with certain sales of securities in violation of the federal securities laws (R. 7a–13a). Although the complaint alleged violations only of Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a), the lower courts also considered

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Court; and it is now inevitable that, if granted, the merits could not be reached until the 1971 Term. The parties were notified that this brief would be filed as soon as the decision to file it was made, on February 18, 1971.

the applicability of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b–5 thereunder, 17 CFR 240.10b–5 (Pet. App. 6a–7a, 34a). See *Hoover* v. *Allen,* 241 F. Supp. 213, 226 n. 7 (S.D. N.Y.).

Specifically, the amended complaint [2] alleges that in January 1962, Bankers Life agreed to sell all the stock of Manhattan to two of the individual defendants in this action—Standish T. Bourne and James F. Begole [3]—for $5 million. (Pet. App. 3a). The purchasers, however, did not pay for the Manhattan stock out of their own funds. Rather, with the aid of the other named defendants, they embarked upon a scheme to use Manhattan's own assets to pay for the purchase of its stock. Simply stated, Bourne and Begole caused Irving Trust Company to issue a check for $5 million on the morning of the closing without any funds to back up the check; on the same day, after securing control, they caused Manhattan to sell $5 million in United States Treasury bonds then in its portfolio, and used the proceeds to cover the Irving Trust Company check.

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[2] For purposes of these proceedings, the complaint is considered as having been expanded by "amendatory allegations presented in open court" which were "not formally set forth in the complaint" (Pet. App. 9a). The motions to dismiss were made five years after the filing of the complaint, and intervening years of discovery were construed by the district court and the court of appeals as having augmented the complaint in the respects thus alleged.

[3] Both Bourne and Begole died prior to petitioner's appeal to the court of appeals; accordingly, they are no longer involved in the proceedings.

Petitioner alleges that Manhattan's board of directors was deceived by some of the defendants into selling these bonds by the misrepresentation that "the sale of the bonds was intended only to effectuate a substitution of those assets for a certificate of deposit equal in value * * *." (Pet. App. 9a). A certificate of deposit for $5 million was obtained in Manhattan's favor; but the certificate was simultaneously pledged as collateral for a $5 million loan in favor of an unrelated corporate entity, making it worthless to Manhattan (Pet. App. 9a). Accordingly, on the basis of the fraudulent representations made to Manhattan's board of directors, "the board was deceitfully induced to authorize the sale of the bonds in exchange for a certificate without value to the corporation" (*ibid*).[4]

On motion the district court dismissed the complaint. 300 F. Supp. 1083 (S.D.N.Y.). The court of appeals affirmed. The affirmance was based in part on questions of petitioner's standing to challenge certain aspects of the fraudulent scheme—questions left open by this Court in *Securities and Exchange Commission* v. *National Securities, Inc.*, 393 U.S. 453, 467 n. 9, but which the Commission does not here discuss.[5] The affirmance also was

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[4] The court recognized that the board of directors had been deceived: "No doubt the deception was successful, for had the [Manhattan] board [of directors] known that [those in control of Manhattan] intended to misappropriate the proceeds for their own use it undoubtedly would not have authorized their sale [Pet. App. 10a]."

[5] The complaint bases the claim of liability alternatively on three securities transactions, each allegedly part of the overall fraudulent scheme which ultimately led Manhattan to liquidation; but it seeks only a single recovery. (Pet. App. 12a n. 9). The

based on the majority's conclusion, Judge Hays dissenting, that as to the issue on which petitioner did have standing, there was no violation of Rule 10b–5, because the alleged fraud was not "in connection with the purchase or sale of any security."

The majority based this conclusion on the following: (1) the "sole object" of the fraud perpetrated "was to obtain possession of Manhattan's" portfolio securities for the personal use of the perpetrators (Pet. App. 10a); (2) neither the purchaser nor the seller was deceived with respect to the *"terms"* of the sale itself (*ibid.*) (emphasis supplied); (3) the fraud consisted of the failure of those in control of Manhattan to account for the proceeds, and did not affect either the securities markets, the investing public or the terms of the sale (Pet. App. 10a–11a); and (4) there was no danger that the securities sold would be overvalued on reaching the public markets (Pet. App. 11a). In short, the court of appeals found that "[t]he purity of the security transaction [here in issue] * * * [was] unsullied" (*ibid*). In urging this Court to grant certiorari, the Commission

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courts below rejected petitioner's standing to base his claim on two of the three fraudulent transactions, citing *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461, 463 (C.A. 2), certiorari denied, 343 U.S. 956. Although the Commission disagrees with the rule of *Birnbaum*—as generally stated, that only an actual purchaser or seller of securities may maintain an action under Section 10(b)—it believes (1) that a cause of action has been stated with respect to the sale of Treasury bonds from Manhattan's portfolio; (2) that this cause of action, if recognized by this Court, would provide petitioner with all the relief he seeks; and (3) that it is not clear, even should the purchaser-seller limitation be rejected by this Court, that petitioner should recover for the other transactions that form the focus of his alternative claims.

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discusses only the question whether this conclusion is sufficient to exclude the application of Section 10(b) and Rule 10b–5; or whether those provisions are violated when an agent of a security-holder induces the security-holder to sell his securities through the agent, upon the misrepresentation that the agent will return the proceeds of the sale to the security-holder, and the agent misappropriates the sale for his own use.

THE INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION

Within the last decade the antifraud provisions of the federal securities laws, and particularly Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b–5 thereunder, have developed into major tools by which to implement Congress' purpose "to prevent frauds in the sale [of] securities sold in interstate and foreign commerce and through the mails" [6] and "to prevent inequitable and unfair practices" [7] in connection with such securities transactions. This Court noted the importance of Section 10(b) and Rule 10b–5 and the public's reliance upon them in *Securities and Exchange Commission* v. *National Securities, Inc., supra*; as Mr. Justice Marshall observed, 393 U.S. at 465, these provisions "may well be the most litigated provisions in the federal securities laws * * *." A major reason for the continually increasing reliance on the federal antifraud provisions has been this Court's refusal to adopt restric-

[6] Preamble, Securities Act of 1933, 48 Stat. 74.

[7] Preamble, Securities Exchange Act of 1934, 48 Stat. 881.

tive constructions and limitations upon these and analogous antifraud provisions,[8] both in Commission enforcement actions and in private actions which serve as a "necessary supplement" to the Commission's own actions. *J. I. Case Co.* v. *Borak*, 377 U.S. 426, 432.

The Commission has a central responsibility to maintain the integrity and scope of these remedies. The rule of law established by the court below poses a serious threat to these antifraud provisions by formalistically and narrowly defining, and severely circumscribing, the scope of the securities transactions to which they apply. Cf. *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375, 379.

DISCUSSION

The question whether Section 10(b) and Rule 10b–5 provide a remedy for an agent's fraudulent inducement of a security-holder to sell his securities through the agent, upon the misrepresentation that the agent will return the proceeds of the sale to the security-holder, is important and recurrent. It was wrongly decided by the court of appeals, in conflict with the decisions of other courts of appeals, the administrative interpretation by the Commission of its own rule, and principles enunciated by this Court. The issue thus merits review by this Court.

1. The central importance of the case is in its interpretation of the language of Section 10(b) and Rule

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[8] See *Securities and Exchange Commission* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195; *Tcherepnin* v. *Knight*, 389 U.S. 332; *Securities and Exchange Commission* v. *National Securities, Inc.*, *supra*, 393 U.S. 453; *J. I. Case Co.* v. *Borak*, 377 U.S. 426; and *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375.

10(b)–5 which limits their application to conduct "in connection with the purchase or sale of any security." The court of appeals construed this language to restrict these provisions to cases in which the alleged wrongdoers are shown to have the purpose of defrauding securities investors, as distinct from a purpose merely to loot a corporation's assets. The Commission does not believe the language is so limited; in its view, the phrase does no more than confine Section 10(b) to cases in which securities are involved as distinct from fraudulent conduct generally.

a. The lower courts' restrictive construction conflicts with the principle that securities legislation should be construed without regard to technical and restrictive notions of intent "but flexibly to effectuate its remedial purposes." *Securities and Exchange Commission* v. *Capital Gains Research Bureau, Inc., supra,* 375 U.S. at 195; see also, *Tcherepnin* v. *Knight, supra,* 389 U.S. at 336; cf. *Ellis* v. *United States,* 206 U.S. 246, 257. The "in connection with" clause "is plainly and—one must assume—intentionally the loosest linkage, in any of the federal antifraud provisions, between a proscribed act and a security transaction." Bromberg, *Securities Law: Fraud-SEC Rule* 10*b*-5, Sec. 7.6(1), p. 190.21. See, *e.g., Herpich* v. *Wallace,* 430 F. 2d 792 (C.A. 5), certiorari denied, March 1, 1971, No. 1078, this Term; *Kahan* v. *Rosenstiel,* 424 F. 2d 161, 172 (C.A. 3), certiorari denied *sub nom. Glen Alden Corp.* v. *Kahan,* 398 U.S. 950; *Hooper* v. *Mountain States Securities Corp.,* 282 F. 2d 195 (C.A. 5), certiorari denied, 365 U.S. 814. Section 10(b) and Rule 10b–5 are applicable irrespective of the dominant motivation, once fraud in a securities

transaction has been shown.[9] Cf. *Capital Gains Research Bureau, supra,* 375 U.S. at 200–201.

b. The court of appeals' opinion raises serious questions of fidelity to Congress' purpose in enacting Section 10(b). That section was intended to be as broad as the Act itself, serving to fill any gaps left by more specific provisions in preventing "cunning devices." Hearings on H.R. 7852 and 8720, *House Committee on Interstate and Foreign Commerce,* 73d Cong., 2d Sess. 115; see also H. Rep. No. 1383, 73d Cong., 2d Sess. 6. The legislative purpose was broad; the wording of the section is correspondingly broad; and the scope of the rule adopted by the Commission to enforce it is intended to be equally broad. "It would have been difficult to frame the authority to prescribe regulations, in broader terms. Had Congress intended to limit this authority to regulations proscribing common-law fraud, it would probably have said so. We see no reason to go beyond the plain meaning of the word 'any,' indicating that the use of manipulative or deceptive devices or contrivance of whatever kind may be forbidden * * *" *Rekant* v. *Desser,* 425 F. 2d 872, 880 n. 15 (C.A. 5). With the exception of the decision below, the courts have generally rec-

[9] See *Kohler* v. *Kohler Co.*, 319 F. 2d 634 (C.A. 7); *Myzel* v. *Fields*, 386 F. 2d 718 (C.A. 8); Bromberg, *Securities Law: Fraud—SEC Rule* 10b–5, Sec. 7.2(4)(e) and 7.6(2)(a), pp. 154.2 and 190.24. Indeed, prior to this opinion, the Second Circuit had unequivocally recognized that motive is irrelevant in determining whether Rule 10b–5 has been violated. *Heit* v. *Weitzen*, 402 F. 2d 909, certiorari denied, 395 U.S. 903; *Securities and Exchange Commission* v. *Texas Gulf Sulphur Co.*, 401 F. 2d 833, certiorari denied *sub nom. Coates* v. *Securities and Exchange Commission*, 394 U.S. 976.

ognized that by the enactment of Section 10(b) Congress intended to prevent inequitable and unfair practices and to ensure fairness in securities transactions generally, whether conducted in the organized securities markets or face-to-face. *Matheson* v. *Armbrust,* 284 F. 2d 670, 674 (C.A. 9).[10]

Indeed, the securities legislation of 1934 was based in large measure on congressional dissatisfaction with rules of the New York Stock Exchange that made the unlawfulness of stock pools turn on proof of motive. As the Senate Committee stated, "Motive furnishes no justification for the employment of manipulative or deceptive devices."[11] It is difficult to believe that the same Congress that considered these stock exchange rules to have been "emasculated by the inclusion of restrictive phraseology"[12] would have intended its own legislation to be read in such a restrictive manner.

2. While it might at first appear troublesome that the securities fraud committed here also occurred in connection with or as a part of internal corporate embezzlement, and that the corporation itself is the defrauded "investor," these circumstances neither detract from the importance of the case nor foreclose petitioner's claim. Section 10(b) and Rule 10b–5 extend pro-

[10] See also, *Herpich* v. *Wallace*, *supra*, 430 F. 2d at 806; *Rekant* v. *Desser*, 425 F. 2d 872 (C.A. 5); *Kahan* v. *Rosenstiel*, *supra*; *Hooper* v. *Mountain States Securities Corp.*, 282 F. 2d 195 (C.A. 5), certiorari denied, 365 U.S. 814. On prior occasions the Second Circuit has adopted this expansive approach to the purpose and coverage of Section 10(b) and Rule 10b–5. See *Securities and Exchange Commission* v. *Texas Gulf Sulphur Co.*, *supra*, 401 F. 2d at 847–848; *Heit* v. *Weitzen*, *supra*.

[11] S. Rep. No. 1455, 73d Cong., 2d Sess. (1934), p. 32.

[12] *Id.* at 49.

tection to "any person," and Section 3(a)(9) of the Securities Exchange Act expressly includes "a corporation" within the definition of a "person." *Hooper* v. *Mountain States Securities Corp., supra,* 282 F.2d at 202. Securities fraud committed in connection with internal corporate affairs remains securities fraud nonetheless. While Congress did not intend to regulate transactions which comprise no more than internal corporate mismanagement, it acted to protect securities investors from all forms of securities fraud, even if corporate looting was the motivating factor or an additional result of the securities fraud perpetrated.[13] Actions instituted by the Commission also bear out this philosophy;[14] the lower court's opinion is in conflict with the numerous court decisions[15] holding that a misappro-

---

[13] See, *e.g.*, *Herpich* v. *Wallace; supra; Rekant* v. *Desser, supra; Pappas* v. *Moss*, 393 F. 2d 865 (C.A. 3); *McClure* v. *Borne Chemical Co.*, 292 F. 2d 824 (C.A. 3), certiorari denied, 368 U.S. 939; *Errion* v. *Connell*, 236 F. 2d 447 (C.A. 9).

[14] See, *e.g.*, *Securities and Exchange Commission* v. *Bowler*, 427 F. 2d 190 (C.A. 4); *Securities and Exchange Commission* v. *Fifth Avenue Coach Lines*, 289 F. Supp. 3 (S.D. N.Y.), affirmed, CCH Fed Sec. L. Rep., para. 92,880 (C.A. 2); *Securities and Exchange Commission* v. *Parvin Dohrmann Co., et al.*, 69 Civ. 4543 (S.D. N.Y.).

[15] *Securities and Exchange Commission* v. *Federal Shopping Way*, Civ. Action No. 7351 (W.D. Wash.), affirmed, 433 F. 2d 148 (C.A. 9); *Securities and Exchange Commission* v. *Bowler, supra;* 427 F. 2d 190 (C.A. 4); *Los Angeles Tr. D. & M. Exch.* v. *Securities and Exchange Commission*, 285 F. 2d 162 (C.A. 9), certiorari denied, 336 U.S. 919; *Stevens* v. *Vowell*, 343 F. 2d 374 (C.A. 10); *Hooper* v. *Mountain States Securities Corp., supra; Securities and Exchange Commission* v. *Culpepper*, 270 F. 2d 241 (C.A. 2); *United States* v. *Monjar*, 147 F. 2d 916 (C.A. 3), certiorari denied, 325 U.S. 859.

priation of funds resulting from a securities sale is within the purview of Section 10(b) and Rule 10b–5.[10]

3. The decision below also conflicts with *Hooper* v. *Mountain States Securities Corp., supra,* 282 F. 2d 195 (C.A. 5), in holding that application of these antifraud provisions was foreclosed once it was conceded that there had been no misrepresentation regarding the investment value of the Treasury bonds sold. See also *Errion* v. *Connell, supra; Stevens* v. *Vowell, supra;* cf. *Mills* v. *Electric Auto-Lite, supra.* The requirement of misrepresentation as to investment value is a novel one, which raises a serious question whether the court of appeals has not exalted form over substance. *Securities*

[10] Almost since the Commission was established, application of Section 10(b) and Rule 10b–5 to misappropriation of investors' funds has been particularly prominent in its regulation of broker-dealers registered with it. See, *e.g., Securities and Exchange Commission* v. *Lawson*, 24 F. Supp. 360 (D. Md.); *Globe Securities Co., Ltd.*, 10 SEC 1105. While it could be urged that the special obligations of broker-dealers to their customers form the basis for the imposition of sanctions for conversion of a customer's securities, (see *e.g.*, Section 8 of the Securities Exchange Act, 15 U.S.C. 78h, and Rule 8c–1, thereunder, 17 CFR 240.8c–1), it may be questioned whether such broker-dealer obligations are any more compelling than the obligations of insiders and controlling shareholders to their corporation. See, *e.g., Speed* v. *Transamerica Corp.*, 99 F. Supp. 808 (D. Del.). And the Commission has generally alleged that such conduct also violates the antifraud provisions of the federal securities laws. In light of the recent concern over brokerage house failures, it is important that no aspect of the Commission's enforcement arsenal be impaired. Cf. *Securities and Exchange Commission* v. *Charles Plohn & Co.*, CCH Fed. Sec. L. Rep., para. 92,843 (C.A. 2); *Securities and Exchange Commission* v. *First Devonshire Corp.*, S.D. N.Y., 70 Civ. 3752; *Securities and Exchange Commission* v. *Robinson & Co.*, E.D. Pa., Civ. Action No. 70–2396.

and Exchange Commission v. *National Securities, Inc.*, *supra*, 393 U.S. at 465. Its decision seriously restricts the reach of the antifraud provisions of the securities laws. This is an important question which should be settled on a national basis through review by this Court.

CONCLUSION

In view of its position on the question discussed, the Commission believes that the petition for a writ of certiorari should be granted.

Respectfully submitted.

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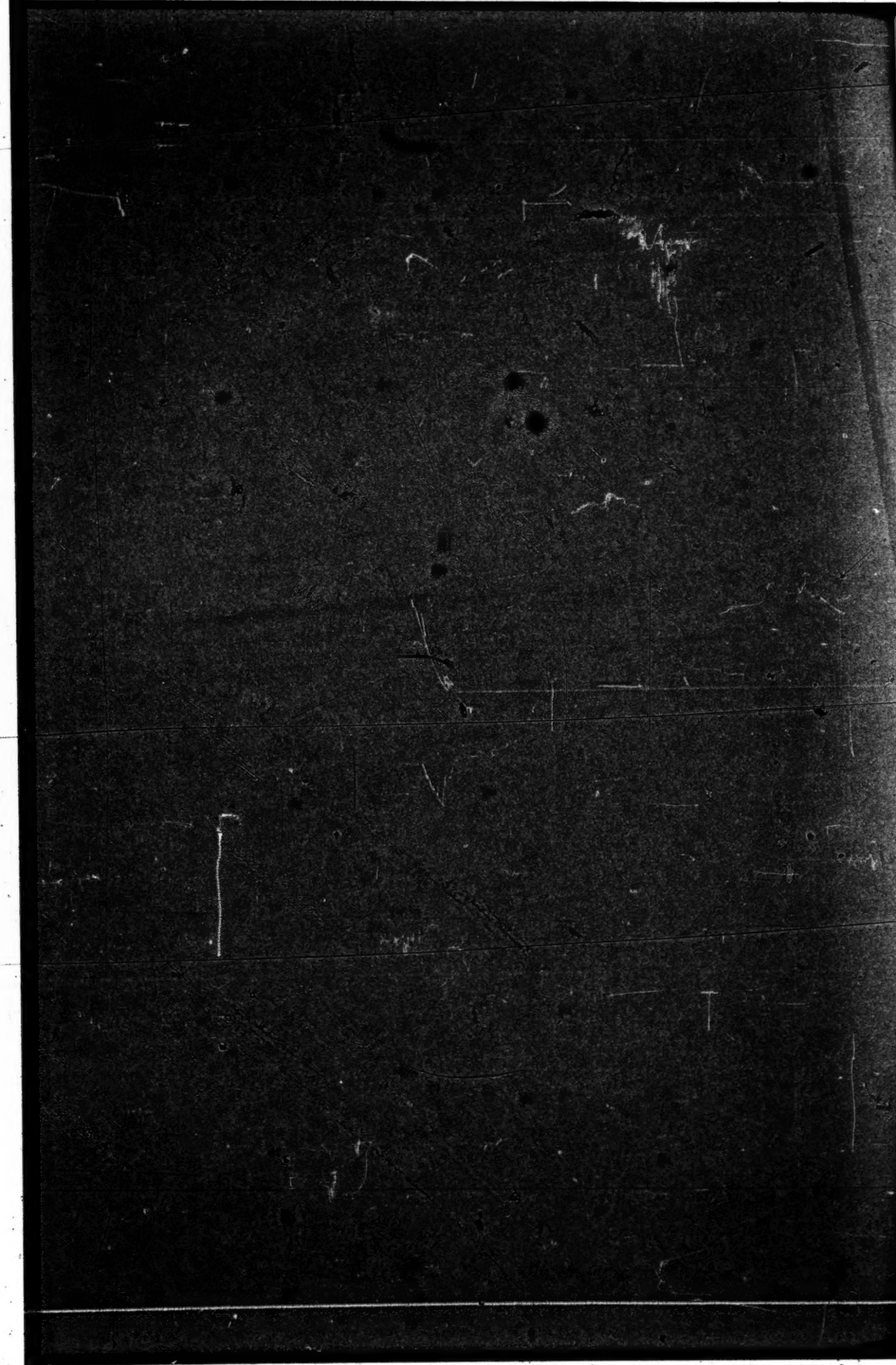
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MARCH 1971.

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[redacted]



IN THE

Supreme Court of the United States

October Term, 1970

No. 1159

SUPERINTENDENT OF INSURANCE OF THE STATE OF NEW YORK, as Liquidator of MANHATTAN CASUALTY COMPANY,
Petitioner,

against

BANKERS LIFE AND CASUALTY COMPANY, IRVING TRUST COMPANY, BELGIAN AMERICAN BANKING CORPORATION, BELGIAN AMERICAN BANK & TRUST COMPANY, GARVIN, BANTEL & COMPANY, GEORGE K. GARVIN,
Respondents.

RESPONDENTS' REPLY TO THE BRIEF FILED FOR THE SECURITIES AND EXCHANGE COMMISSION

The patently unique facts in this case, ignored by the Commission, deprive it of any claimed precedential value. Not a single known case and certainly not a single case cited by the Commission presents facts, such as are present here, of a sole stockholder who is alleged to have misappropriated the proceeds of the sale of his own corporation's securities for his own use. Thus, the Commission mistakenly asserts that the purported question it presents and discusses "is important and recurrent."

The Commission, although appearing to agree with the courts below that no federal claim can be stated with respect to the purchase of Manhattan's outstanding capital stock or the purchase of various certificates of deposit, by its sole purported "Question Presented" would have this Court believe that, in respect of the sale of its government bonds, this case involves an "agent's fraudulent inducement" of a

"security holder" to sell securities as if the "agent" were a broker and the "security holder" his customer. The Commission is wholly mistaken as to what this case involves. Here, the so-called "agent" was the sole stockholder of the "security holder" and engineered his own self-inflicted fraud. Such a factual situation is wholly unique and unlikely to recur.

The Commission's brief unjustly criticizes the opinion of the Court of Appeals. In no respect did that court impugn the integrity or scope of the remedies made available by the 1934 Act. In no respect did that court establish a rule of law which poses a threat—to say nothing of a "serious threat"—to the anti-fraud provisions.

The Commission's belated effort to construct an "important question" involving the securities laws must fail because the tendered question is not presented under the circumstances of this case.

The Petition should be denied and petitioner should be left to pursue his long-pending case in the state court.

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March 15, 1971

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1970

No. ~~1159~~ 70-60

Superintendent of Insurance of the State of New York, as Liquidator of MANHATTAN CASUALTY COMPANY,

Petitioner,

versus

BANKERS LIFE AND CASUALTY COMPANY, ET AL.,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1970

No. 1159

Superintendent of Insurance of the State of New York, as Liquidator of MANHATTAN CASUALTY COMPANY,

Petitioner,

versus

BANKERS LIFE AND CASUALTY COMPANY, ET AL.,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR PETITIONER

Opinions Below

The opinion of the Court of Appeals for the Second Circuit is reported at 430 F.2d 355 (1970) and is set forth at pages 97a-108a of the appendix.* The opinion of Judge Herlands of the District Court for the Southern District of New York is reported at 300 F.Supp. 1083 (1969) (A. 50a). The opinion of Judge Ryan of the District Court for the Southern District of New York is not officially reported but is printed in the appendix at 89a.

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* Citations to appendix will hereinafter appear "(A. —)".

Jurisdiction Of This Court

The judgment of the Court of Appeals to be reviewed was entered on July 22, 1970 (A. 111a). The petition for rehearing and rehearing en banc was denied by orders dated September 30, 1970 (A. 112a and 113a). The petition for certiorari was filed in this Court on December 24, 1970, and certiorari was allowed on March 22, 1971 (A. 114a). The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

Statutes and Regulations Involved

This is an action for damages based on violations of section 17(a) of the Securities Act of 1933, hereinafter the Securities Act, 15 U.S.C. section 77q(a), 3 United States Code at 2658 (1964 edition), and section 10(b) of the Securities Exchange Act of 1934, hereinafter the Exchange Act, 15 U.S.C. section 78j(b), 3 United States Code at 2698 (1964 edition), together with Rule 10b-5, 17 CFR section 240.10(b)(5) at 296 (revised as of Jan. 1, 1970), promulgated thereunder.

Section 17(a) of the Securities Act states:

> "It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make

the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

Section 10(b) of the Exchange Act states:

"Section 10 It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Rule 10b-5 provides:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security."

Questions Presented

1. Did the Court below err in affirming the dismissal of the complaint where the record disclosed that a board of directors was fraudulently induced to authorize the sale of securities owned by a corporation and the proceeds of such sale were wrongfully diverted from the corporation?

2. Are Rule 10b-5 and Section 10(b) violated where full value is paid by a purchaser of securities and the proceeds are immediately misappropriated by corporate seller's management and others as part of a fraudulent scheme to loot the corporation of its assets?

3. Are the purposes of the Securities Exchange Act of 1934 and § 10(b) served by finding a violation to exist herein?

4. Should the strict purchaser-seller limitations enunciated in *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952), cert. denied, 343 U.S. 956 (1952) be abolished?

5. Has the Court of Appeals, in holding that Petitioner has not alleged a federal cause of action in connection with the transactions involving certificates of deposit, ruled erroneously?

Statement of the Case

A. Procedural History

In May, 1963, the Superintendent of Insurance of the State of New York (Petitioner) was appointed Liquidator of Manhattan Casualty Company (Manhattan) by order of the New York State Supreme Court (Sup. Ct., N.Y. Co., Index No. 40931/1963). That order vested Petitioner with all the rights of action of Manhattan. In that capacity, Petitioner commenced this action in August, 1963. The Petitioner was not a party to the transactions complained of, nor did he possess first hand knowledge of the events in question. The complaint was drawn on the basis of facts disclosed at hearings held by the Insurance Department of the State of New York in connection with proceedings which led to the liquidation of Manhattan.

After six and one half years of extensive discovery, yielding approximately 12,000 pages of testimony and 500 documents marked for identification, additional facts foreshadowed by the allegations in the complaint have come to light and are included in the record.

The Note of Issue was filed on August 31, 1967. On April 17, 1968, defendant Bankers Life and Casualty Company (Bankers Life) moved in the United States District Court for the Southern District of New York for summary judgment. Judge Sylvester J. Ryan denied that motion without prejudice, and suggested that the questions of subject matter jurisdiction and Petitioner's standing to sue be reached *in limine* (A. 40a).

Accordingly, Bankers Life, defendant Belgian American Banking Corporation (Belgian Banking) and Belgian American Bank and Trust Company (Belgian Trust)

moved to dismiss this action pursuant to Rules 12(c) and 12(h) of the Federal Rules of Civil Procedure before the late Judge William B. Herlands. Defendants Irving Trust Company (Irving Trust), Garvin Bantel & Company (Garvin, Bantel) and George K. Garvin (Garvin) made identical motions before Judge Ryan. Both motions were granted by judgments entered on June 4, 1969 and June 17, 1969, respectively (A. 91a, 93a, 95a).

Petitioner appealed and on July 22, 1970, the United States Court of Appeals for the Second Circuit affirmed the judgments of the District Court. Judge Hays dissented. Although the majority opinion found as did Judge Herlands, that a fraud had been committed, the Court held that Petitioner had failed to allege a claim for relief under the federal securities acts. This Court allowed certiorari by order filed on March 22, 1971 (A. 114a).

B. The Facts

1. *Sale of Manhattan Stock.*

Manhattan was the victim of a fraudulent scheme whereby it was purchased with and looted of its assets. Until January 24, 1962, Bankers Life was the sole stockholder of Manhattan. The fraudulent scheme is reflected in the following events. On that day, Bankers Life sold its stock in Manhattan for $5,000,000 to a purchasing group which included Standish T. Bourne (Bourne) and James F. Begole (Begole). Bourne and Begole arranged in advance with Irving Trust that it would issue its check for $5,000,000 in payment of the purchase price to Bankers Life. On January 24, 1962, Irving Trust sent an officer with a check for $5,000,000 to attend the closing of the sale of the stock. At that closing he delivered the check made payable to Bankers Life as the purchase price for Manhattan stock.

At this point in time, Manhattan did not maintain an account at Irving Trust. Shortly after the closing, the entire Manhattan portfolio of government securities totaling almost $5,000,000 was sold to Second District Securities which delivered a check in the amount of $4,854,552.67 to Irving Trust representing the proceeds of the sale. Manhattan transferred cash to Irving to bring the total to $5,000,000. Irving Trust promptly applied the proceeds against the $5,000,000 check it had delivered to Bankers Life earlier that morning. These transactions, as well as those of the afternoon of January 24, 1962, were conceived by Garvin, a general partner in the note brokerage firm of Garvin, Bantel.

The perpetrators deceived Manhattan's board of directors into voting approval for the sale of Manhattan's portfolio of United States Government Bonds by representing that the proceeds would be used to purchase a certificate of deposit (CD) (A. 115a-122a). In short, Manhattan sold securities worth almost $5,000,000 as a result of the deception of its board of directors and received nothing in return.

In order to conceal the depletion of $5,000,000 of assets and Manhattan's resultant insolvency, a paper asset had to be created. As part of the scheme, Garvin and Garvin, Bantel had arranged in advance for a check swap to take place among three financial institutions on that very afternoon. Irving Trust issued a $5,000,000 check in the name of Manhattan which was tendered to Belgian Trust. Belgian Trust then issued a $5,000,000 CD in the name of Manhattan. John F. Sweeny (Sweeny), newly installed as President of Manhattan after its sale that morning, endorsed the CD over to New England Note Corporation (New England Note), a company controlled by Bourne. Bourne then endorsed the CD over to Belgian Banking, which used the

CD as collateral for a so-called $5,000,000 loan to New England Note. A Belgian Banking check for $5,000,000 representing the New England Note loan was immediately given to Irving Trust to repay it for its check to Belgian Trust. Thus an asset in identical amount to that of which Manhattan was defrauded was created in its name and carried on its books as cash without reference to its total hypothecation, for the sole purpose of concealment.

Belgian Banking made a second loan to New England Note in the amount of $250,000 which was distributed in part as follows: Belgian Banking $100,000, Bourne $50,000 Begole $50,000, and Garvin, Bantel $25,000.

At the close of January 24, 1962, ownership of the shares of Manhattan had been transferred. Irving Trust had issued two $5,000,000 checks. It was reimbursed in full for the first from the assets of Manhattan. It was reimbursed in full for the second by the check of Belgian Banking representing the proceeds from the so-called loan to New England Note for which a CD in the name of Manhattan served as collateral.

During this period, Manhattan had no account at Irving Trust. In order to conceal the transactions, Irving made a series of false entries on its books. These entries were supported by backdated letters obtained for Irving by Garvin from Bourne. The acts described above were all part of one fraudulent scheme designed to gain control of Manhattan by using its assets to meet the purchase price.

2. *Events subsequent to January 24, 1962.*

On July 24, 1962, the CD and the alleged loans made by Belgian Banking and Belgian Trust to New England Note matured. To continue to conceal the depletion of Manhattan's assets, Bourne, Garvin and Garvin, Bantel, Begole,

Belgian Banking and Belgian Trust arranged to renew the loans and to issue a new CD to be held as collateral in the manner of January 24, 1962. However, at this point Sweeny, the President of Manhattan and a member of its board, now fearful, objected to the fact that the certificate was to be hypothecated. The other named defendants therefore misrepresented to him and consequently to Manhattan whose agent he was, that the certificate to be issued would not be held as collateral and that the stock of Manhattan would be the sole collateral for the loans to New England Note. In fact, it was arranged for Begole to issue a letter to Belgian Trust and Belgian Bank indicating that the new CD was being held as collateral for the loans, which he did and Belgian Bank so held it thereafter. Thus Sweeny was induced through fraud to purchase a new CD which was rendered valueless to Manhattan by the acts of the schemers. The schemers made it appear that Belgian Trust owed $5,000,000 plus interest to Manhattan evidenced by the new CD, that Manhattan further had on deposit at Belgian Trust a sum in excess of $5,000,000 and New England Note owed Belgian Banking $5,250,000.

Since Sweeny insisted on keeping physical possession of the new certificate to display as the need might arise, Belgian Trust, to further conceal the true facts, issued another CD covering the same funds so that Belgian Bank might retain one to display to New York State bank examiners as collateral for the renewed loan.

Furthermore, in August 1962 Belgian Trust and Belgian Banking contrived to have Sweeny return the CD that had been given to him in July and to endorse a negotiable certificate in Manhattan's name. To accomplish this the bank official signed a letter falsely representing that the CD issued in July was being held in trust by Belgian Trust

for Manhattan, whereas in fact Belgian Trust agreed to sign this letter to obtain Sweeny's endorsement of the CD. Thereafter, Belgian Banking held the CD as collateral for the loan to New England Note under the letter of instructions issued by Begole without authorization from Manhattan. The endorsement of the July CD rendered it valueless to Manhattan. Sweeny's signature as Treasurer of Manhattan (an office he then held) was necessary to effect the collateralization and he was induced to sign only after it had been misrepresented to him that the certificate was to be held in trust and not as collateral. Sweeny, however, endorsed the certificate in his capacity as President of Manhattan which was ineffective to establish a collateralization. This was subsequently changed to "Treasurer" by another hand after the certificate was in the possession of Belgian Banking.

In August, 1962, Manhattan transmitted a CD for $500,000 drawn on the First National Bank of Boston which it owned free of all encumbrances, to Belgian Trust to be held in trust for safekeeping. However, in January 1963 the Belgian Trust CD matured and the loans (in the amount of $5,000,000 and $250,000 to New England Note and Bourne, respectively) fell due. Therefore, to continue to conceal the depletion of Manhattan's assets another series of misrepresentations was made which also resulted in the loss of this asset to Manhattan. The original plan was to effect a direct pair-off of the $5,000,000 CD against the $5,000,000 loan and to use the $500,000 CD to pay the interest on the $5,000,000 loan. The $250,000 loan was to be shipped to Boston together with the stock of Manhattan to be held by the Boston financial institution as collateral. However, this plan was discovered and thwarted by Sweeny.

Bourne, Garvin and Garvin, Bantel, Belgian Trust, Belgian Banking, Irving Trust and Begole then conspired

to effect the pair-off of CD's against the loans to New England Note in the following manner. It was misrepresented to Sweeny and Manhattan that Irving Trust would issue $5,500,000 worth of CD's for the account of Manhattan and that the loans for which the Belgian Trust certificates were being held as collateral were to be refinanced. Sweeny was told to instruct Belgian Trust to deliver the proceeds of those CD's to Irving Trust to effect payment for the new CD's to be issued by Irving Trust for Manhattan. Relying on this misrepresentation, Sweeny instructed Belgian Trust to pay the proceeds to Irving Trust. In fact, Garvin had arranged for his clearance bank, Marine Midland, to effect payment on $5,500,000 bearer certificates, which it did, and Irving Trust transmitted such certificates to Marine Midland. There they were held as collateral for the loan to Garvin by which payment was effected. Garvin then caused Irving Trust to issue a check payable to Belgian Banking in the amount of $5,250,000, presumably to pay off the loans to New England Note. However, this was nothing more than a check swap between Irving Trust, Belgian Banking, and Belgian Trust employed to make it appear that outside monies had been used to pay off the loans. Upon receipt of the Irving Trust check in the amount of $5,250,000, Belgian Trust drew a check payable to Irving Trust in the amount of $5,500,000 which it did and Irving Trust transmitted such certificates of interest which was paid into Manhattan's account) which were now held free and clear for Manhattan since the loans for which they had been held as collateral had been paid by the Irving Trust check. This check was supposed to be released to Irving Trust to effect payment on the Irving Trust CD's pursuant to Manhattan's letter of instruction signed by Sweeny to Belgian Trust. When Irving Trust received this money, instead of crediting it to Manhattan's account it was used to offset the $5,250,000 check it had

issued at Garvin's request payable to Belgian Banking and both checks were passed through the account of Garvin, Bantel.

Summary of Argument

The decision below is an unjustifiably narrow and technical interpretation of the scope of §10(b) of the Exchange Act and Rule 10b-5. Although the existence of a fraud is rceognized by the lower courts, it was determined to be not "in connection with" the purchase or sale of a security. It is the Petitioner's position (1) that the inducement of the board of directors by means of fraudulent material misrepresentations of fact to approve the sale of a corporate portfolio of United States Treasury bonds which results in the loss of an asset to the corporation is a violation of Rule 10b-5; (2) that the misappropriation of the proceeds from a corporate sale of securities is a violation of Rule 10b-5; (3) that in the light of the purposes for which the Exchange Act was enacted, a federal cause of action exists; (4) that a fraudulent scheme whereby a corporation is purchased with portfolio securities owned by the corporation is a scheme to defraud under Rule 10b-5. The corporation should have standing to recover losses it suffered as a result of the scheme and if necessary for this result, *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952), cert. denied, 343 U.S. 956 (1952) should be overruled.

I.A. §10(b) and Rule 10b-5 are violated when a board of directors is fraudulently induced to authorize the sale of securities owned by a corporation which results in the loss of an asset. It does not follow that merely because misrepresentations of investment value are actionable under 10b-5, that more outrageous types of misrepresentations are not actionable. See, *Hooper* v. *Mountain States Secu-*

rities Corp., 282 F.2d 195 (5th Cir. 1960), cert. denied, 365 U.S. 814, 81 S. Ct. 695 (1961). Misrepresentations that a seller will receive the proceeds from a sale of securities when in fact the perpetrators intend to convert said proceeds are also actionable. *Puharich* v. *Borders Electronics Co.*, CCH FED. SEC. L. REP. ¶92,141 (S.D.N.Y. 1968); *Goodman* v. *Hentz & Co.*, 265 F.Supp. 440 (N.D. Ill. 1967). This Court has held that misrepresentations in proxy solicitations unrelated to the terms of sale were within the purview of §14(a) of the Exchange Act. *Mills* v. *Electric Autolite Co.*, 396 U.S. 375, 90 S. Ct. 616 (1970). There is no reason why the conclusion reached in *Mills, supra* should not control 10b-5 actions.

To say, as did the Court of Appeals that the only fraud harmful to Manhattan was the failure of the perpetrators to account for the proceeds of the sale is to ignore the unity of the scheme: without the sale of the bonds (the securities transaction) there would have been no acquisition; without the fraud (deception of the board) there would have been no sale of bonds.

An allegation of fraud in the nature of deceit, practiced on the decision-making body of a corporation inducing a sale of securities which results in injury to the corporation, is sufficient to defeat a motion to dismiss the complaint for lack of subject matter jurisdiction. *Ruckle* v. *Roto American Corp.*, 339 F.2d 24 (2d Cir. 1964); *Dasho* v. *Susquehanna Corp.*, 380 F.2d 262 (7th Cir. 1967), cert. denied sub nom. *Bard* v. *Dasho*, 389 U.S. 977, 88 S. Ct. 480 (1967); *Globus, Inc.* v. *Jaroff*, 266 F.Supp. 524 (S.D.N.Y. 1967).

Where a corporation loses an asset as a result of a fraudulently induced securities transaction, the corporation may recover. *Hooper* v. *Mountain States Securities Corp.*, 282

F.2d 195 (5th Cir. 1960), cert. denied, 365 U.S. 814, 81 S. Ct. 695 (1961).

B. The fraudulent deprivation of the seller of the consideration bargained for in a sale of securities, even when committed by corporate insiders, is a Rule 10b-5 violation. *Puharich* v. *Borders Electronics Co.*, CCH FED. SEC. L. REP. ¶92,141 (S.D.N.Y. 1968); *Parker* v. *Baltimore Paint & Chemical Corp.*, 244 F.Supp. 267 (D. Col. 1965). Violators of Rule 10b-5 are not immunized from civil liability merely because their violations are part of a broader scheme of corporate mismanagement, even if corporate looting is the object or result of the securities fraud. *Rekant* v. *Desser*, 425 F.2d 872 (5th Cir. 1970); *Herpich* v. *Wallace*, 430 F.2d 792 (5th Cir. 1970); *Pappas* v. *Moss*, 393 F.2d 865 (3rd Cir. 1968). The policy of the Exchange Act would be frustrated if Rule 10b-5 were denied application in a case where a securities transaction was an integral part of the fraud merely because of the availability of a remedy in a state court.

C. The language of §10(b) and Rule 10b-5 is so plain that it obviates the need to examine extraneous matter in explanation of its meaning. Respondents' fraud comes within the common sense meaning of the statutory language. Further, it comes within the judicial test as set forth in *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 860 (2d Cir. 1968) (en banc), cert. denied sub nom. *Coates* v. *SEC*, 394 U.S. 976, 89 S. Ct. 1454 (1969) defining which frauds are "in connection with" a securities transaction.

It was incorrectly determined by the Court of Appeals that "the public interest" base for Rule 10b-5 was limited to protecting the integrity of the securities markets. The provisions of §78b of the Exchange Act indicate that the public interest was to prevent business losses caused by fraudulent

dealings in securities. Since Manhattan lost $5,500,000 as a result of respondents' fraudulent dealings in securities with Manhattan, the public interest is served by finding a cause of action under §10(b) to exist herein.

II. The Court of Appeals relied on *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952), cert. denied, 343 U.S. 956 (1952) to hold that since Manhattan was neither the purchaser nor seller of its stock, it lacked standing to sue even though the stock was purchased with Manhattan's portfolio bonds. *Birnbaum* survives even though this Court has repeatedly held that the goals of the securities acts are not to be frustrated by judicial interpretation. In addition, many lower courts have questioned *Birnbaum's* validity and have expanded the definitions of "purchaser" and "seller" in order to avoid the limiting effect of the purchaser-seller requirement.

No private right of action existed when Rule 10b-5 was promulgated. The SEC intended to regulate those against whom actions could be brought, not those on whose behalf private actions could be brought. The SEC promulgated the rule under its duty to protect the public at large as well as investors in securities. Further, the SEC has consistently argued as amicus that there is not and ought not to be a mechanical purchaser-seller test for determining standing to sue under Rule 10b-5. Therefore, the purchaser-seller restriction enunciated in *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952), cert. denied, 343 U.S. 956 (1952) should be abolished.

Manhattan was the victim of a "scheme to defraud." Since the vital center of the scheme was the sale of Manhattan's stock, it is unrealistic to say that the fraud was not committed "in connection with the purchase or sale of any security." To hold otherwise can only serve to ossify a

statutory scheme designed to be flexible and to create greater incentive for clever scheming.

III. Those issues raised in connection with the purchase and sale of Manhattan's bonds are also raised in connection with the purchase and sale of CD's subsequent to January 24, 1962. The arguments set forth in I, *supra,* are incorporated herein.

ARGUMENT

I.

The Court below erred in affirming the dismissal of the complaint where the record disclosed that a board of directors was fraudulently induced to authorize the sale of securities owned by a corporation and the proceeds of such sale were diverted from the corporation.

That Manhattan was the victim of a fraud was recognized both by the District Court and the Court of Appeals. Judge Herlands stated:

> "The complaint in this case presents no more than a complicated scheme of common law fraud." (A. 88a).

The majority opinion of the Court of Appeals stated:

> "What distinguishes the fraud perpetrated on Manhattan in this case from . . . ." (A. 105a)
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> • • •
>
> "No doubt the deception was successful, for had the board known that Sweeny and his associates intended to misappropriate the proceeds for their own use it undoubtedly would not have authorized their sale." (A. 105a).

The only issue to be resolved is whether or not the fraud perpetrated on Manhattan is one which is federally cognizable.

Although some facts presented in support of the claim on appeal do not appear in the complaint, the Court of Appeals properly considered them. *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 430 F.2d 355, 360 (2d Cir. 1970).

The majority of the court below rejected jurisdiction under Rule 10b-5 on the grounds that the fraud was not committed "in connection with the purchase or sale of any security." Their decision was based on the following: (1) neither the purchaser nor the seller of Manhattan's bonds was deceived or defrauded with respect to the *terms of the sale* itself (A. 105a) (emphasis added); (2) the only fraud which harmed Petitioner was the failure of the perpetrators to account for the proceeds (A. 106a); (3) the *sole object* of the fraud was to obtain possession of Manhattan's bonds for the personal use of the perpetrators (A. 105a) (emphasis added); (4) the purposes of the federal securities legislation would not be served by holding Respondents' acts to be "in connection with" a securities transaction since the fraud did not affect the investing public nor the securities markets and there was no danger that the securities sold would be overvalued on reaching the public market (A. 106a-107a).

A. § 10(b) and Rule 10b-5 are Violated When a Board of Directors is Fraudulently Induced to Authorize the Sale of Securities of a Corporation.

The Court recognized that the board of directors of Manhattan was induced by misrepresentations to approve the sale of bonds. The Court held, however, that since the board was deceived as to the misappropriation of the pro-

ceeds from the sale and not as to the terms of the sale (i.e. value of the bonds or the consideration paid for them), there was no violation of Rule 10b-5. The three cases cited in support of this distinction are *Ruckle* v. *Roto American Corp.*, 339 F.2d 24 (2d Cir. 1964); *Globus, Inc.* v. *Jaroff*, 266 F.Supp. 524 (S.D.N.Y. 1967); and *Simon* v. *New Haven Board & Carton Co.*, 250 F.Supp. 297 (D. Conn. 1966). Each one of them upheld 10b-5 jurisdiction where the board of directors or shareholders were induced by misrepresentations of investment value into approving a sale or purchase of securities. However, there is no language in any of these decisions that limits federal jurisdiction to misrepresentations of investment value. Where it is alleged that a corporation has been defrauded into selling securities because the approval necessary for the transaction was induced by material misrepresentations of any kind, federal jurisdiction exists. Since this principle controls where the misrepresentations or omissions of material fact concern such things as the financial condition of a company or investment value, e.g., *Schoenbaum* v. *Firstbrook*, 405 F.2d 215 (2d Cir. 1968) (en banc), cert. denied sub nom. *Manley* v. *Schoenbaum*, 395 U.S. 906, 89 S. Ct. 1747 (1969); *Pappas* v. *Moss*, 393 F.2d 865 (3rd Cir. 1968); *Ruckle, supra; Simon, supra*, certainly where the falsehoods involved are far more outrageous in that they conceal or fail to disclose that the seller will receive nothing for the asset it is deceived into surrendering, jurisdiction must also exist. See, *Stevens* v. *Vowell*, 343 F.2d 374 (10th Cir. 1965); *SEC* v. *Federal Shopping Way Inc.*, No. 7351 (W.D.N.D. Wash. August 6, 1969) aff'd, 433 F.2d 149 (9th Cir. 1970) (in which deposits were made into personal bank accounts carried in a corporate name so that endorsements on checks would not reveal the conversion); *Puharich* v. *Borders Electronics Co.*, CCH Fed. Sec. L. Rep. ¶92,141 (S.D.N.Y. 1968); *Good-*

man v. *Hentz & Co.*, 265 F.Supp. 440 (N.D. Ill. 1967). In *Goodman, supra* at 444-445, the Court stated:

> "The fact that the fraud was so substantial that entire transactions intended by plaintiffs to be purchases and sales for their accounts, amounted to complete conversions of their funds by Rubloff, does not deprive plaintiff's of their right to recover under the Securities Act, a right they clearly would have if Rubloff had perpetrated lesser frauds, such as misrepresentations concerning quality of stocks he recommended to them [citation omitted]; . . . . If there is any difference between the fraud in these cases and the fraud in the case at bar, it is only that the latter is more odious, because the customer loses his entire investment."

Not one cited authority indicates that jurisdiction should be denied, as did the Court below in the instant matter, if the misrepresentations inducing the transaction did not concern the terms of the sale of the securities themselves. In fact, the judgment appealed from represents the first time a federal court has so limited the scope of Rule 10b-5. This Court has held that in the fraudulent solicitation of proxies, the fact that the misrepresentation had nothing to do with the terms of the sale or that the sale itself was fair is irrelevant for purposes of determining whether plaintiff has stated a federal cause of action. *Mills* v. *Electric Autolite Co.*, 396 U.S. 375, 90 S. Ct. 616 (1970). There, this Court stated, at 396 U.S. 382, 90 St. Ct. 620:

> "The result [of permitting all liability to be foreclosed on the basis of a finding that the transaction was fair] would be to insulate from private redress an entire category of proxy violations—those relating to matters other than the terms of the merger. Even

> outrageous misrepresentations in a proxy solicitation, if they did not relate to the terms of the transaction, would give rise to no cause of action under § 14(a). Particularly if carried over to enforcement actions by the Securities and Exchange Commission itself, such a result would subvert the congressional purpose of ensuring full and fair disclosure to shareholders."

Although *Mills, supra,* concerned proxy solicitations under § 14(a) of the Exchange Act, the same reasoning should control in Rule 10b-5 actions. To hold otherwise would insulate from private redress that entire category of misrepresentations relating to matters other than the terms of the sale—a result that this Court has already rejected in *Mills.*

In applying the "terms of the sale test", the Court below conflicted with its earlier decision in *A. T. Brod & Co.* v. *Perlow,* 375 F.2d 393 (2d Cir. 1967). There, the Court held, at 375 F.2d 396-397:

> "Neither § 10(b) nor Rule 10b-5 contains any language which would indicate that those provisions were intended to deal only with fraud as to the investment value of securities, and, indeed, it is established that a 10b-5 action will survive even though the fraudulent scheme or device is unrelated to investment value. * * * Nor do we think it sound to dismiss a complaint merely because the alleged scheme does not involve the type of fraud that is 'usually associated with the sale or purchase of securities.' We believe that § 10(b) and Rule 10b-5 prohibit all fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws."

The Court of Appeals reasoned that since the "sole object [of the fraud] was to obtain possession of Manhattan's government bonds for the personal use of the perpetrators," it was not cognizable under Rule 10b-5 (A. 105a). This construction conflicts with the principle that federal securities legislation should be construed without regard to technical and restrictive notions of intent "but flexibly to effectuate its remedial purposes." *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195, 84 S. Ct. 275, 284-285 (1963). As the Senate Committee stated, "Motive furnishes no justification for the employment of manipulative or deceptive devices." S. Rep. No. 1455, 73d Cong., 2d Sess. (1934).

To say, as did the Court of Appeals, that the only fraud harmful to Manhattan was the failure of the perpetrators to account for the proceeds from the sale is to ignore the unity of the scheme. The perpetrators of the fraud recognized that in order to obtain the funds necessary to pay Bankers Life for the stock of Manhattan, the board of directors would be required to authorize the sale of bonds owned by Manhattan. These bonds were ultimately the source of funds with which Manhattan was purchased. Without the sale of the bonds (the securities transaction) there would have been no acquisition; without the fraud (deception of the board) there would have been no sale of bonds. There is no logic in separating the deception of the board from the sale of securities it authorized. Indeed, the Court below accepted the fact that had the board not been deceived, it would not have authorized the sale of securities (A. 105a).

The device here used to dislodge the bonds from the corporation was fraud in the nature of deceit, practiced upon the decision-making body of the corporation inducing a sale of securities which resulted in injury to the cor-

poration. This allegation of federal fraud is sufficient to defeat a motion to dismiss the complaint. See, e.g., *Ruckle, supra, Dasho* v. *Susquehanna Corp.*, 380 F.2d 262 (7th Cir. 1967), cert denied sub nom. *Bard* v. *Dasho*, 389 U.S. 977, 88 S. Ct. 480 (1967); *Hooper* v. *Mountain States Securities Corp.*, 282 F.2d 195 (5th Cir. 1960), cert. denied, 365 U.S. 814, 81 S. Ct. 695 (1961); *Erling* v. *Powell*, 429 F.2d 795 (8th Cir. 1970); *Globus, supra; Parker* v. *Baltimore Paint and Chemical Corp.*, 244 F.Supp. 267 (D. Col. 1965); *Simon* v. *New Haven Board and Carton Co.*, 250 F.Supp. 297 (D. Conn. 1966); *O'Neill* v. *Maytag*, 230 F.Supp. 235, 239 (S.D.N.Y. 1964); *Dauphin* v. *Sentinel Alarm Corp.*, 206 F.Supp. 432 (D. Del. 1962). In the District Court's terminology, this is an impure transaction in securities, one tainted by fraud and deceit.

Petitioner is in precisely the same position as was the plaintiff in *Hooper* v. *Mountain States Securities Corp.*, 282 F.2d 195 (5th Cir. 1960), cert. denied, 365 U.S. 814, 81 S. Ct. 695 (1961). There, a trustee in bankruptcy was recognized as a proper party to maintain an action on behalf of the corporation which had been defrauded. A transfer agent was fraudulently induced to issue corporate stock by misrepresentations that a sale had occurred and was approved by the board of directors. Upon the issuance of $700,000 worth of securities by the transfer agent, the corporation was given worthless properties. No sale or approval had taken place. The Court, in effect, constructed a sale to bring the case within Rule 10b-5. The Fifth Circuit held that the misrepresentations made to the transfer agent inducing the "sale" constituted a violation of Rule 10b-5 where the corporation received inadequate consideration. In short, all that must be established to support federal jurisdiction is injury to the corporation as a result of a fraudulent securities transaction. See,

Hoover v. *Allen*, 241 F.Supp. 213 (S.D.N.Y. 1965); *New Park Mining Co.* v. *Cranmer*, 225 F.Supp. 261 (S.D.N.Y. 1963); *Simon* v. *New Haven Board & Carton Co.*, 250 F.Supp 297 (D. Conn. 1966). Manhattan was injured by the sale of its securities because it received no consideration at all. The *Hooper* Court rested its holding on the theory that the treasury stock of the corporation was an asset of that corporation having a specific value, and that what amounted to the loss of that asset was a loss to the company for which recovery was allowed. It said, in pertinent part, at 282 F.2d 203:

> "... we would be blind to all we hear and read about were we to succumb to the artificial contention that the issuance of this stock made the corporation no poorer so that the only persons who suffered were the stockholders for whom the suit cannot be brought ... considering the purpose of this legislation it would be unrealistic to say that a corporation having the capacity to acquire $700,000 worth of assets has suffered no loss if what it gave up was $700,000 but what it got was zero. If—as we very much doubt—accountants would support any such contention as a consequence of the esoteric mysteries of the double entry system, the law with its eye on reality, would have to part company with such purists."

Again, as Judge Herlands said in another case:

> "Plaintiffs allege that the defendants' scheme will directly result in the final transfer of the stock to Borders without receipt of that consideration. Surely, that is a sufficient charge of injury to the corporation." *Puharich* v. *Borders*, CCH FED. SEC. L. REP. ¶ 92,191 (1968).

B. § 10(b) and Rule 10b-5 are Violated When the Proceeds From a Sale of Securities are Misappropriated.

Assuming, *arguendo,* that the board was not induced by misrepresentations into authorizing the sale of bonds, the mere fraudulent deprivation from the seller of the consideration bargained for, even when committed by corporate insiders, is a violation of Rule 10b-5. *Puharich* v. *Borders Electronics Co., supra; Parker* v. *Baltimore Paint & Chemical Corp.,* 244 F.Supp. 267 (D. Col. 1965). In *Parker, supra,* the Court noted that acts amounting to corporate mismanagement, namely, conversion of the sale price, were fraudulent acts in connection with the earlier sale of securities which in itself was pure. Thus, if the sale of bonds was not fraudulently induced, and if the proceeds from the sale were paid into Manhattan's account (assuming for the moment that Manhattan had an account), and the proceeds were then converted by corporate insiders pursuant to the scheme to pay Irving Trust for the check to Bankers Life, a violation of Rule 10b-5 would still exist. See, *Cooper* v. *North Jersey Trust Co.,* 226 F.Supp. 972 (S.D.N.Y. 1964); *United States* v. *Robertson,* 181 F.Supp. 158 (S.D.N.Y. 1959) aff'd, 298 F.2d 739 (2d Cir. 1962); *In re Calvert,* 35 S.E.C. 141 (1953); *In re Lockaby,* 29 S.E.C. 271 (1949). See also: *Allico Nat'l Corp.* v. *Amalgamated Meat Cutters,* 397 F.2d 727 (7th Cir. 1968).

Respondents attempt to wish away the existence of an intricate securities fraud by arguing that the securities transactions which were the heart of the scheme were merely incidental to acts of corporate waste and mismanagement. They conclude that such acts were not intended to be remedied by the federal securities laws. (Respondents' Brief In Opposition To The Petition For A Writ of Certiorari at 5, 7). A majority of the Court of Appeals agreed. However the Court and Respondents disre-

garded the plain fact that each fraudulent act including the misappropriation of the proceeds by defendants was a vital part of one scheme and the successful perpetration of the scheme damaged the corporation to the extent of $5,500,000. The Court below has severed the misappropriation of proceeds from the sale of bonds and held that the misappropriation allegations (which constitute corporate mismanagement also) standing alone do not constitute a 10b-5 case. The Court, however, is

> "not at liberty to disregard [Petitioner's] allegations and to now hold that the charges are unrelated." *Parker* v. *Baltimore Paint & Chemical Corp.*, 244 F. Supp. 267, 270 (D. Col. 1965).

As the District Court recognized:

> "The direct involvement of the deceit with a transaction in securities is fraud 'in connection with' the sale of the stock, and consequently constitutes federal fraud irrespective of whether it also constitutes corporate mismanagement." *Superintendent of Insurance* v. *Bankers Life and Casualty Co.*, 300 F.Supp. 1083, 1102-1103 (S.D.N.Y. 1969) (A. 85a).

Violators of Rule 10b-5 are not immunized from civil liability for their unlawful acts merely because those acts were committed as part of a broader scheme of corporate mismanagement, *Herpich* v. *Wallace*, 430 F.2d 792 (5th Cir. 1970); *Landay* v. *United States*, 108 F.2d 698 (6th Cir. 1939) cert. denied, 309 U.S. 681, 60 S. Ct. 721 (1940); *Kane* v. *Central American Mining & Oil, Inc.*, 235 F.Supp. 559, 564 (S.D.N.Y. 1964); *New Park Mining Co.* v. *Cranmer*, 225 F.Supp. 261, 266 (S.D.N.Y. 1963); even if corporate looting is the object or result of the securities fraud. *Rekant* v. *Desser*, 425 F.2d 872 (5th Cir. 1970); *Herpich*

v. *Wallace*, 430 F.2d 792 (5th Cir. 1970); *Pappas* v. *Moss*, 393 F.2d 865 (3rd Cir. 1968). See, *Errion* v. *Connell*, 236 F.2d 447, 454 (9th Cir. 1956).

A federal cause of action under § 10(b) and Rule 10b-5 exists "notwithstanding that the perpetrators of the fraud are corporate insiders liable under state law." *Rekant* v. *Desser*, 425 F.2d 872, 882 (5th Cir. 1970). See, *J.I. Case* v. *Borak*, 377 U.S. 426, 84 S. Ct. 1555 (1964); *Matheson* v. *Armbrust*, 284 F.2d 670, 673 (9th Cir. 1960), cert. denied, 365 U.S. 870, 81 S. Ct. 904 (1961); *Vine* v. *Beneficial Finance Co.*, 374 F.2d 627 (2d Cir. 1967), cert. denied, 389 U.S. 970, 88 S. Ct. 463 (1967); *O'Neill* v. *Maytag*, 339 F.2d 764 (2d Cir. 1964). It would frustrate the policy of the Exchange Act if Rule 10b-5 was denied application in a case where a securities transaction was an integral part of the fraud merely because of the availability of a remedy in a State Court. *O'Neill* v. *Maytag*, 339 F.2d 764, 768 (2d Cir. 1964) (dictum); cf. *Voege* v. *American Sumatra Tobacco Corp.*, 241 F.Supp. 369, 375 (D. Del. 1965); Note, Private Enforcement Under Rule 10b-5: An Injunction For A Corporate Issuer, 115 U. Pa. L. Rev. 618, 621 (1967). Moreover, § 78bb(a) of the Exchange Act permits a remedy under the Act in addition to any state and other federal remedies:

> "The rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity"

Thus, the misappropriation of the proceeds from the sale of Manhattan's bonds was itself a fraud in connection with a securities transaction. Even if deemed to be an act of corporate mismanagement, the misappropriation is nevertheless actionable under 10b-5 as being an act committed as part of an overall fraudulent scheme.

C. The Purposes of the Securities Exchange Act of 1934 Are Served by Finding a Violation of § 10(b) and Rule 10b-5.

The language of §10(b) and Rule 10b-5 is so plain that it obviates the need to examine extraneous matter in explanation of its meaning. See, *Fratt* v. *Robinson*, 203 F.2d 627 (9th Cir. 1953). It is apparent that respondents' fraud comes within the statutory language, ". . . in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered any manipulative or deceptive device . . ." in the common sense meaning of those words. §78j(b) of the Exchange Act.

"We see no reason to go beyond the plain meaning of the word 'any', indicating that the use of manipulative or deceptive devices or contrivance of whatever kind may be forbidden. . ." *Rekant* v. *Desser*, 425 F.2d 872, 880 n.15 (5th Cir. 1970).

It cannot be successfully contended that the fraud perpetrated on the board of directors was not "in connection with" a securities transaction. It has been repeatedly held that a fraud is "in connection with" a securities transaction where:

> ". . . the device employed, whatever it might be, be of a sort that would cause reasonable investors to rely thereon, and, in connection therewith, so relying, cause them to purchase or sell a corporation's securities."

SEC v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 860 (2d Cir. 1968) (en banc), cert. denied sub nom. *Coates* v. *SEC*, 394 U.S. 976, 89 S. Ct. 1454 (1969). Accord, *Heit* v. *Weitzen*, 402 F.2d 909 (2d Cir. 1968), cert. denied, 395 U.S. 903, 89 S. Ct. 1740 (1969); *City Nat'l Bank* v. *Vanderboom*, 422 F.2d 221 (8th Cir. 1970), cert. denied, 399 U.S. 905, 90 S. Ct. 2196 (1970); *Herpich* v. *Wallace*, 430 F.2d 792, 806 (5th Cir.

1970). It is evident from these cases that the purpose of §10(b) and Rule 10b-5 is to ensure disclosure that would effect decisions to buy or sell securities. See also, *Tcherepnin* v. *Knight*, 389 U.S. 332, 88 S. Ct. 548 (1967). Its application is called for in any case where the defrauding management (and/or outsiders) is not the sole decision-making body. *Fleischer, Federal Corporation Law: An Assessment*, 78 HARV. L. REV. 1146, 1163 (1965). The misrepresentations inducing the board of directors to authorize the sale of bonds calls for the application of §10(b) and Rule 10b-5.

In order to direct the Court's attention away from the unambiguous language of §10(b) and Rule 10b-5, respondents have argued and the lower courts agreed that the statutory purposes would not be served by finding the fraud to be "in connection with" a securities transaction. The Second Circuit had repeatedly given a broad construction to the "in connection with" clause. See, *Ruckle* v. *Roto American Corp., supra; Vine* v. *Beneficial Finance Co., supra; Crane Co.* v. *Westinghouse Air Brake Co.*, 419 F.2d 787 (2d Cir. 1969), cert. denied, 400 U.S. 822, 91 S. Ct. 41 (1970). The Court of Appeals has now departed from its precedents and put a limiting interpretation on §10(b), contrary to the well founded principle that the securities acts are remedial provisions that should be construed broadly and flexibly. *Tcherepnin* v. *Knight*, 389 U.S. 332, 336, 88 S. Ct. 548, 553 (1967); *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195, 84 S. St. 275, 284-285 (1963); *Herpich* v. *Wallace*, 430 F.2d 792 (5th Cir. 1970); *Kahan* v. *Rosenstiel*, 424 F.2d 161, 172 (3rd Cir. 1970), cert. denied sub nom. *Glen Alden Corp.* v. *Kahan*, 398 U.S. 950, 90 S. Ct. 1870 (1970); *Hooper* v. *Mountain States Securities Corp., supra.*

The regulation has two bases—"in the public interest" or "for the protection of investors." §78j(b) of the Exchange Act.

> "Each [base] fully justified the regulation. Its [the regulation] validity does not therefore depend on its being issued 'for the protection of investors.'"

Hooper, supra at 202. The Court of Appeals found that the public interest cognizable by §78j(b) is limited to preserving the integrity of the securities markets (A. 107a). To equate "the public interest" with "preserving the integrity of the securities markets" is to eliminate one of the independent bases of the regulation. By preserving the integrity of the securities markets, it is not the public, but the investors who are protected. Therefore, "the public interest" must mean something other than the limited definition offered by the Court of Appeals. Congress and the courts have furnished guidelines as to what is defined as "the public interest."

In §78b of the Exchange Act, Congress states that it is regulating securities transactions because they

> "involve the use of credit, directly affect the financing of trade, industry, and transportation in interstate commerce, and directly affect and influence the volume of interstate commerce; and affect the national credit." §78b(1)(d).

Congress was concerned with

> "National emergencies, which produce widespread unemployment and the dislocation of trade, transportation, and industry, and which burden interstate commerce and adversely affect the general welfare . . ., and to meet such emergencies the Federal Government

is put to such great expense as to burden the national credit.' §78b(4).

These provisions reflect the national economic emergency that led to their enactment. The public interest was not merely to protect the securities markets, but it was to prevent bankruptcies and business losses caused by fraudulent dealings in securities. See *Hooper* v. *Mountain State Securities Corp., supra,* (keep the channels of interstate commerce pure from fraudulent schemes, tricks, devices); *Herpich* v. *Wallace, supra,* (maintain a viable vigorous business community); *Silver* v. *New York Stock Exchange,* 196 F. Supp. 209 (S.D.N.Y. 1961) rev'd, 302 F.2d 714 (2d Cir. 1962) rev'd, 373 U.S. 341, 83 S. Ct. 1246 (1963) (protect national economy and national financial system); *American Sumatra Tobacco Corp.* v. *SEC,* 110 F.2d 117 (D.C. Cir. 1940) (protect banks in which loans are secured by such securities as collateral). This precise evil is the subject of the instant suit: respondents' fraudulent dealings with Manhattan in securities led to its bankruptcy. The public interest contemplated by Congress in enacting the Exchange Act is served by finding a cause of action under §10(b) to exist herein.

It is not essential, therefore, that for a corporation to come under §10(b) and Rule 10b-5 it have the status of an investor. *Hooper* v. *Mountain State Securities Corp.,* 282 F.2d 195, 202 (5th Cir. 1960); *New Park Mining Co.* v. *Cranmer, supra.* In holding that Rule 10b-5 was violated even though 1) plaintiff was not an investor, 2) no fraud was alleged with regard to investment value of securities and 3) there was no danger that thin or watered stock would be distributed, the Second Circuit stated:

"Neither §10(b) nor Rule 10b-5, it appears, speaks in terms of limiting the nature of the violation to one

involving fraud of 'investors'; nor is there any justification for reading such an additional requirement into the Act." *A.T. Brod & Co.* v. *Perlow,* 375 F.2d 393, 396 (2d Cir. 1967).

§ 10(b) was intended to be as broad as the Act itself, serving to fill any gaps left by more specific provisions in preventing "cunning devices." Hearings on H.R. 7852 and 8720, *House Committee On Interstate and Foreign Commerce,* 73d Cong., 2d Sess. 115; See also H. Rep. No. 1383, 73d Cong., 2d Sess. 6 (1934). Congress created a structure and legal framework for the whole field of securities designed to be flexible and to meet unforeseen problems, and to deal not only with problems attendant upon the trading of securities through organized markets. H.R. Rep. No. 85, 73d Cong. 1st Sess. 2-4 (1933); H.R. Rep. No. 1383, 73d Cong, 2d Sess. 2-5 (1934). This is likewise true of the anti-fraud provisions. Loss, L., *Securities Regulation,* at 1467 (2d ed. 1961). In enacting the anti-fraud provisions, Congress was attempting to prohibit any acts in contravention of the overall philosophy of the maintenance of a fraud-free post-issuance securities market to complement and support those other provisions contained in the acts designed to insure the absence of fraud in the issuance of securities. *Brennan* v. *Midwestern United Life Insurance Co.,* 259 F.Supp. 673 (D. Ind. 1966) 417 F.2d 147 (7th Cir. 1969), cert. denied, 397 U.S. 989, 90 S. Ct. 1122 (1970).

The "in connection with" clause "is plainly and—one must assume—intentionally the loosest linkage, in any of the federal anti-fraud provisions, between a proscribed act and a security transaction." Bromberg, A., *Securities Law: Fraud—SEC Rule 10b-5,* § 7.6(1), p. 190.21 (1969). See, *Rekant* v. *Desser,* 425 F.2d 872, 880 n. 15 (5th Cir. 1970).

From an examination of the statutory provisions, judicial interpretations, and legislative history, it must be con-

cluded that the purposes of the federal securities acts would be served by holding the fraud alleged in the instant case to be "in connection with" a securities transaction.

II.

The purchaser-seller restriction enunciated in *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952), cert. denied, 343 U.S. 956 (1952) should be abolished.

Without reaching the question of whether Petitioner alleged a violation of Rule 10b-5 in connection with the purchase and sale of the Manhattan stock, the Court of Appeals found that since Manhattan was neither a purchaser or seller of the stock, it lacked standing to sue. The Court relied on *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952), cert. denied, 343 U.S. 956 (1952) and its reaffirmation in *Greenstein* v. *Paul*, 400 F.2d 580 (2d Cir. 1968).

This Court has long held that the goals of the securities acts ought not be frustrated by judicial interpretation. *E.g.*, *SEC* v. *W. J. Howey Co.*, 328 U.S. 293, 66 S. Ct. 1100 (1946); *SEC* v. *C.M. Joiner Leasing Corp.*, 320 U.S. 344, 64 S. Ct. 120 (1949); *Deckert* v. *Independence Share Corp.*, 311 U.S. 282, 61 S. Ct. 229 (1940); and this view has continued down to the present. *Mills* v. *Electric Autolite Co.*, 396 U.S. 375, 90 S. Ct. 616 (1970); *SEC* v. *National Securities*, 393 U.S. 453, 89 S. Ct. 564 (1969); *J.I. Case* v. *Borak*, 377 U.S. 426, 84 S. Ct. 1555 (1964); *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 84 S. Ct. 275 (1963). The conception of what is a cognizable fraud under the securities acts has undergone a process of development and expansion. The history of the acts and Rule in the courts

has left no doubt that a plaintiff need not meet the five-element test of common law fraud. This is clearly indicated from the text of § 17(a) and Rule 10b-5. Each of these have three subdivisions which read in the disjunctive.

Subdivision (1) is the catch-all provision which speaks of any device, scheme or artifice to defraud, and that is all. Subdivision (2) speaks of affirmative misrepresentation either by a false statement or by the omission to make a necessary statement under the circumstances. Subdivision (3) combines elements of the foregoing subdivisions. Thus it speaks of both fraud and deceit and treats misrepresentation by actions as well as otherwise. The clear purport of both the statute and the rule was to inspire maximum application.

The courts have recognized the artificiality of the limitation imposed by the purchaser-seller rule. See, *SEC* v. *National Securities, supra,* (dissenters thought majority had loosely construed *Birnbaum*); *Hooper* v. *Mountain State Securities Corp.*, 282 F.2d 195 (5th Cir. 1960); *Vine* v. *Beneficial Finance Co.*, 374 F.2d 627 (2d Cir. 1967), cert. denied, 389 U.S. 970, 88 S. Ct. 463 (1967); *Rekant* v. *Desser,* 425 F.2d 872 (5th Cir. 1970); *Kahan* v. *Rosenstiel,* 424 F.2d 161 (3rd Cir. 1970), cert. denied sub nom. *Glen Alden Corp.* v. *Kahan,* 398 U.S. 950, 90 S. Ct. 1870 (1970) (injunctive relief); *Stockwell* v. *Reynolds,* 252 F.Supp. 215 (S.D.N.Y. 1965).

Similarly the SEC has consistently argued as amicus that there is not and ought not to be a mechanical purchaser-seller test for determining standing to sue under Rule 10b-5. *Vine* v. *Beneficial Finance Co., supra; Pacific Insurance Co.* v. *Blot,* 267 F.Supp. 956 (S.D.N.Y. 1967).

Where a private right of recovery is court-created it is likewise within the proper powers of the court to determine

the scope of that right. The court in *Birnbaum* relied heavily on the statement of the SEC that Rule 10b-5 closed a loophole with regard to fraudulent purchases of securities in holding the right of action to be limited to defrauded purchasers or sellers, rather than on the legislative history of the act. The SEC originally promulgated the rule under its duty to protect the public at large and investors in securities (See Point IC, *infra*). It would seem both judicially proper and appropriate for the courts to rely as heavily today on the position of the SEC in interpreting its own rule as they did in 1952.

Furthermore, it should be noted that Rule 10b-5 was promulgated in 1942, fully four years before a private action for fraud was recognized by the courts. The SEC was concerned at the time with those against whom actions could be brought, not those on whose behalf private actions could be brought, since no private right of action existed at the time.

The Court of Appeals, however, felt it was bound by its decision in *Greenstein* v. *Paul,* 400 F.2d 580 (2d Cir. 1968). The Court there held that it was necessary for a plaintiff to have been either a purchaser or seller of securities to sustain federal jurisdiction in an action for damages. Unlike *Greenstein, supra,* Petitioner here is not seeking a speculative recovery. Petitioner's damages were fixed by its actual losses of $5,500,000, and is thus entitled to sue in the federal courts for damages resulting from the violation of the securities laws. As Judge Hays stated in his dissenting opinion (A. 109a):

> "Manhattan was the victim of a 'scheme . . . to defraud' (Rule 10b-5). * * * Since the vital center of the scheme, the vehicle for the perpetration of the fraud, was the sale of Manhattan's stock, it seems

to me to be completely unrealistic to say that the fraud was not committed 'in connection with the purchase or sale of any security.'"

To hold otherwise when not demanded by law, logic, or sound principles of statutory interpretation can only serve to ossify a statutory scheme designed to be flexible and to create greater incentive for clever scheming.

III.

The Court of Appeals erroneously ruled that petitioner failed to allege a federal cause of action in connection with the transactions in certificates of deposit.

Subsequent to January 24, 1962, Manhattan was the victim of several separate and distinct proscribed schemes or devices over the following fifteen month period before the facts came to light and Manhattan was placed in liquidation. The schemes or devices are described in The Facts at pp. 6 through 12, *supra*.

Those issues raised in connection with the purchase and sale of Manhattan's bonds are also raised in connection with the purchase and sale of CD's subsequent to January 24, 1962. The Court of Appeals held that Petitioner failed to state a violation of Rule 10b-5 with regard to the latter set of transactions on substantially the same grounds given for denying jurisdiction regarding the events of January 24, 1962: that regardless of any deceit inducing the transactions or misapplication of proceeds after the transactions, as long as the CD's were bought and sold for their full face amount, there was no fraud in connection with their purchase and sale within the meaning of Rule 10b-5.

Petitioner expressly incorporates herein the arguments set forth in I *supra* establishing that the Court of Appeals has ruled erroneously on these issues.

Furthermore, Manhattan was defrauded in connection with the sale of the $500,000 First National Bank of Boston CD. As a result of the misrepresentations to Sweeny, Manhattan's agent, the proceeds from the sale of the CD were diverted to pay off the debt of New England Note. Sweeny, as President of Manhattan, had authorized its sale only to effect payment for a new certificate. Petitioner is therefore entitled to recover on behalf of Manhattan and its creditors as a defrauded seller of securities within the meaning of § 10(b) and Rule 10b-5.

Petitioner is further entitled to recover as the defrauded purchaser of the Irving Trust CD's under §17(a). The monies paid by Manhattan to effect payment on the CD's issued by Irving Trust were diverted and paid into the account of Garvin pursuant to the scheme, and the CD's were delivered to Marine Midland where they were held as collateral for a loan to Garvin and Garvin, Bantel.

There is only one sum of money in the amount of $5,500,000 involved in all these schemes and separate recovery for each of the separate and distinct fraudulent schemes is not demanded in excess of that amount. Nonetheless, liability would attach at any one of a number of junctures along the path that led to the liquidation of Manhattan. At each, Manhattan had an asset or a potential asset which was rendered valueless to, or the proceeds of which were diverted away from Manhattan. Indeed these fraudulent transactions, although distinct violations, can be viewed as being part of the original purchase and sale transactions of January 24, 1962. They were the direct result of the fact that Manhattan never received any consideration for its bonds sold that day.

CONCLUSION

The allegations of the complaint as amplified by the record before the Court discloses that the board of directors of Manhattan was fraudulently induced to authorize the sale of securities. The deception of the board was part of an overall scheme to loot the assets of Manhattan by selling its securities. As part of that scheme and as a separate fraudulent act in connection with the sale of securities, the proceeds from such sale were misappropriated so that Manhattan sold a valuable asset and received nothing in return.

The Court below, although recognizing the existence of a fraud, erred in not finding it to be a federally cognizable fraud under §10(b) and Rule 10b-5. Furthermore, Petitioner has established its standing to sue in connection with the purchase and sale of Manhattan's stock. For the foregoing reasons, it is respectfully submitted that the judgment of the Court below should be reversed and the cause remanded to the District Court for trial.

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- Section 10(b), 15 U.S.C. 78j(b) — *passim*
- Section 28(a), 15 U.S.C. 78bb(a) — 10

New York Insurance Law:
- Section 78(2) — 6
- Section 511 — 4
- Section 513 — 4
- Section 514(2) — 4

Rules under the Securities Exchange Act, 17 C.F.R. 240, *et seq.*:
- Rule 8c-1, 17 C.F.R. 240.8c-1 — 20
- Rule 10b-5, 17 CFR 240.10b-5 — *passim*

Miscellaneous:

Bromberg, *Securities Law: Fraud—S.E.C. Rule 10b-5* — 10, 13, 17

Comment, *The Prospect for Rule X-10-B-5: An Emerging Remedy for Defrauded Investors*, 59 Yale L.J. 1120 (1950) — 10

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2 Securities and Exchange Commission, *Institutional Investor Study Report*, H.R. Doc. No. 92-64, 92d Cong., 1st Sess. 27

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In the Supreme Court of the United States

OCTOBER TERM, 1970

No. 1159

SUPERINTENDENT OF INSURANCE OF THE STATE OF NEW YORK, AS LIQUIDATOR OF MANHATTAN CASUALTY COMPANY, PETITIONER

v.

BANKERS LIFE AND CASUALTY COMPANY, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION AS AMICUS CURIAE

OPINIONS BELOW

The opinion of the court of appeals (App. 97a) is reported at 430 F. 2d 355. The opinions of the district court (App. 50a, 89a) are reported at 300 F. Supp. 1083.

JURISDICTION

The judgment of the court of appeals was entered on July 22, 1970. A timely petition for rehearing

and suggestion of rehearing *en banc* were denied on September 30, 1970. The petition for a writ of certiorari was filed on December 24, 1970, and was granted on March 22, 1971. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTION PRESENTED

The Commission will discuss the following question: Whether Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b–5 thereunder provide a remedy for a corporate insider's fraudulent inducement of the board of directors of a corporation holding securities to sell those securities on the misrepresentation that the insider would invest the proceeds of the sale for the benfit of the corporation.

STATUTES AND RULES INVOLVED

Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a), provides:

> 17. (a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), provides:

10. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * * * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b–5 promulgated by the Commission under the Securities Exchange Act of 1934, 17 CFR 240.10b–5, provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(1) To employ any device, scheme, or artifice to defraud,

(2) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made,

in the light of the circumstances under which they were made, not misleading, or

(3) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

STATEMENT

The court of appeals upheld a district court decision which dismissed a complaint for failure to state a cause of action under the federal securities laws. This action was brought by the Superintendent of Insurance of the State of New York, as Liquidator of Manhattan Casualty Company ("Manhattan").[1] Manhattan was a New York corporation engaged in the casualty insurance business and was wholly owned by, but under management separate from, defendant Bankers Life and Casualty Company ("Bankers Life") (App. 51a). The complaint alleges generally that each of the defendants was a participant in a scheme to defraud Manhattan in connection with certain sales of securities in violation of the federal securities laws (App. 7a, 13a). Although the complaint alleged violations of only Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a), the lower

[1] N.Y. Ins. Law §§ 511, 513 (McKinney, 1966). Among other things, liquidation of a New York insurance company may be predicated on the insurer's insolvency. By operation of law, the superintendent is vested with the title to all of the property, contracts and rights of action of the insurer as of the date of the entry of the order of liquidation. N.Y. Ins. Law § 514(2) (McKinney, 1966).

courts also considered the applicability of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b–5 thereunder, 17 CFR 240.10b–5 (App. 6a–7a, 66a). See *Hoover* v. *Allen*, 241 F. Supp. 213, 226 n. 7 (S.D. N.Y.).

Specifically, the amended complaint[2] alleges that in January 1962, Bankers Life agreed to sell all the stock of Manhattan to two of the individual defendants in this action—Standish T. Bourne and James F. Begole[3]—for $5 million (App. 98a). The purchasers, however, did not pay for the Manhattan stock out of their own funds. Rather, with the aid of the other named defendants, they embarked upon a scheme to use Manhattan's own assets to pay for the purchase of its stock. Bourne and Begole caused Irving Trust Company, through one of its officers, to issue a check for $5 million on the morning of the closing, although they had no funds on deposit there to cover the check; on the same day, after securing control of Manhattan, they caused Manhattan to sell $5 million in United States Treasury bonds then in

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[2] For purposes of these proceedings, the complaint is considered as having been expanded by "amendatory allegations presented in open court" which were "not formally set forth in the complaint" (App. 104a). The motions to dismiss were made five years after the filing of the complaint, and intervening years of discovery were construed by the district court and the court of appeals as having augumented the complaint in the respects thus alleged.

[3] Both Bourne and Begole died prior to petitioner's appeal to the court of appeals; accordingly, they are no longer involved in the proceedings. More recently, another individual defendant, George K. Garvin, has also died.

its portfolio, and used the proceeds to cover the Irving Trust Company check.

Petitioner alleges, in effect, that, as part of the overall scheme, Manhattan's board of directors was deceived by some of the defendants into selling these bonds by the misrepresentation that "the sale of the bonds was intended only to effectuate a substitution of those assets for a certificate of deposit equal in value * * *" (App. 105a). A certificate of deposit for $5 million was obtained in Manhattan's name in a separate paper transaction, which did not involve any use of the bond-sale proceeds. This certificate was pledged at its creation as collateral for a $5 million loan in favor of an unrelated corporate entity, which in turn used that loan to pay for the issuance of the certificate. The certificate was thus in fact worthless to Manhattan,[4] although it was carried on Manhattan's books without showing its use as collateral, perpetuating the fraud by making it appear that the promise to the board of directors had been carried out (App. 105a). In sum, on the basis of the fraudulent representations made to Manhattan's board of directors, "the board was deceitfully induced to authorize the sale of the bonds in exchange for a certificate without value to the corporation" (App. 105a).[5]

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[4] Indeed, it has been held in a criminal trial of this matter under New York State Insurance law, N.Y. Ins. Law § 78(2) (McKinney, 1966), that "the certificates [of deposit] were never assets of Manhattan." *People* v. *Sweeny*, 27 N.Y. 2d 138, 148.

[5] The court recognized that the board of directors had been deceived: "No doubt the deception was successful, for had

On motion, the district court dismissed the complaint (App. 50a, 89a). The court of appeals affirmed (App. 97a). The affirmance rested in part on petitioner's lack of standing to challenge certain aspects of the fraudulent scheme—questions this Court left open in *Securities and Exchange Commission* v. *National Securities, Inc.*, 393 U.S. 453, 467, n. 9.[6] The

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the [Manhattan] board [of directors] known that [those in control of Manhattan] intended to misappropriate the proceeds for their own use it undoubtedly would not have authorized their sale" (App. 105a).

[6] The complaint alleges that three securities transactions, all part of the overall scheme, each violated Section 10(b), but seeks only a single recovery (App. 108a, n. 9). The court of appeals held that, under *Birnbaum* v. *Newport Steel Corp.*, 193 F. 2d 461, 463 (C.A. 2), certiorari denied, 343 U.S. 956, petitioner had no standing to challenge two of those transactions, but that he had standing to challenge the third transaction, the sale by Manhattan of the Treasury bonds.

Birnbaum held that only an actual purchaser or seller of securities may maintain an action for damages under Section 10(b). The Commission disagrees with this principle, and other courts of appeals have questioned or limited it. See, *e.g.*, *Kahan* v. *Rosenstiel*, 424 F. 2d 161 (C.A. 3), certiorari denied *sub nom. Glen Alden Corp.* v. *Kahan*, 398 U.S. 950; *Coffee* v. *Permian Corp.*, 434 F. 2d 383 (C.A. 5). The Commission believes, however, that this Court need not reach the question. Petitioner seeks only a single recovery and if the complaint states a cause of action with respect to the Treasury bonds (as to which Manhattan concededly was the seller), petitioner can recover all he is seeking under that theory. Conversely, if this claim is legally insufficient or if petitioner cannot prove fraud with respect to the sale of those bonds, he also could not recover under his two other theories.

In dismissing the portion of the complaint challenging the sale of the Treasury bonds, the court of appeals relied upon the further holding in *Birnbaum* that "Section 10(b) * * * was directed solely at that type of misrepresentation or fraud-

affirmance also was based on the majority's conclusion, Judge Hays dissenting, that as to the issue on which petitioner did have standing, there was no violation of Rule 10b–5, because the alleged fraud was not committed "in connection with the purchase or sale of any security." Save for the brief passage in note 6, *supra*, this is the only issue discussed.

The majority based this conclusion on the following reasoning: (1) the "sole object" of the fraud "was to obtain possession of Manhattan's" portfolio securities for the personal use of Bourne and Begole (App. 105a); (2) neither the purchaser nor the seller was deceived with respect to the "terms" of the sale itself (*ibid.*); (3) the fraud consisted of the failure of those in control of Manhattan to account for the proceeds, and did not affect either the securities markets, the investing public or the terms of the sale (App. 105a-107a); and (4) there was no danger that the securities sold would be overvalued on reaching the public markets (App. 107a). In short, the court of appeals found that "[t]he purity of the security transaction [here in issue] * * * [was] unsullied" (*ibid.*).

THE INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION

Within the last decade the antifraud provisions of the federal securities laws, and particularly Section

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ulent practice usually associated with the sale or purchase of securities rather than at fraudulent mismanagement of corporate affairs." 193 F. 2d at 464. The suggestion in *Birnbaum* that Section 10(b) does not reach fraudulent corporate mismanagement is discussed *infra*, pp. 22-25.

10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, have developed into major tools for implementing Congress' purpose "to prevent frauds in the sale" of "securities sold in interstate and foreign commerce and through the mails"[7] and "to prevent inequitable and unfair practices"[8] in connection with securities transactions. This Court noted the importance of Section 10(b) and Rule 10b-5 and the public's reliance upon them in *Securities and Exchange Commission* v. *National Securities, Inc.*, *supra*; as the Court observed, 393 U.S. at 465, these provisions "may well be the most litigated provisions in the federal securities laws * * *." A major reason for the continually increasing reliance on the federal antifraud provisions has been this Court's refusal to adopt restrictive constructions and limitations upon these and analogous antifraud provisions,[9] both in Commission enforcement actions and in private actions which serve as a "necessary supplement" to the Commission's own actions. *J.I. Case Co.* v. *Borak*, 377 U.S. 426, 432.

The Commission has a central responsibility to maintain the integrity and scope of these remedies. The rule of law established by the court below poses

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[7] Preamble, Securities Act of 1933, 48 Stat. 74.

[8] Preamble, Securities Exchange Act of 1934, 48 Stat. 881.

[9] See *Securities and Exchange Commission* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195; *Tcherepnin* v. *Knight*, 389 U.S. 332; *Securities and Exchange Commission* v. *National Securities, Inc.*, *supra*, 393 U.S. 453; *J.I. Case Co.* v. *Borak*, 377 U.S. 426; and *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375.

a serious threat to these antifraud provisions by formalistically and narrowly defining, and severely circumscribing, the scope of the securities transactions to which they apply. Cf. *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375, 379.

The Commission also is concerned because of the court of appeals' apparent view (App. 107a) that the availability of a remedy under state law for the alleged fraud is relevant in determining the applicability of the federal securities laws. When Congress enacted the latter laws in 1933 and 1934, it obviously was aware that many of the acts it prohibited also were illegal under state law.[10] It concluded, however, that federal regulation was necessary because the conduct involved had substantial national implications (see Section 2 of the Securities Exchange Act, 15 U.S.C. 78b), and because state law was thought to be inadequate to deal with these problems for several reasons. For example, the substantive standards of state law often were unduly restrictive, and the procedural requirements of state law often created serious obstacles to vindication of investors' rights.[11]

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[10] Sections 16 and 18 of the Securities Act of 1933 (15 U.S.C. 77p and 77r) and Section 28(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78bb(a)) all specifically recognize the regulatory overlap between state and federal law.

[11] See, *e.g.*, I Loss, *Securities Regulation* 3, 20-22, 105-107 (2d ed., 1961). The problems of state law actions are discussed generally in Comment, *The prospect for Rule X-10B-5: An Emerging Remedy for Defrauded Investors*, 59 Yale L.J. 1120, 1123-1126 (1950); Bromberg, *Securities Law: Fraud—SEC Rule 10b-5*, Sec. 2.7 (1967).

These and similar conditions still exist. See, *e.g.*, *Hooper* v. *Mountain States Securities Corp.*, 282 F. 2d 195, 201 (C.A. 5), certiorari denied, 365 U.S. 814; *Matheson* v. *Armbrust*, 284 F. 2d 670, 673-674 (C.A. 9). Moreover, testimony at recent Congressional hearings reflects state concern over "the growing national problem of the infiltration of organized crime in the insurance * * * business", involving the take-over and looting of insurance companies; [12] there also have been a number of recent government suits challenging schemes to obtain control of and to loot insurance companies.[13] It would be a most unsatisfactory basis for determining the coverage of the federal securities laws to have to decide, on a case-to-case basis, whether state law would provide an adequate remedy for the particular fraud involved.

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[12] *Hearings Before the Subcommittee on Antitrust and Monopoly of the Senate Committee on the Judiciary: The Insurance Industry*, 91st Cong., 1st Sess. pt. 16, p. 9834 (1969). See, also, *id.* at 9810, 9820, 9830, 9841, 10037, 10042-10043; and pt. 15 at pp. 8817-8821, 9039, 9048.

[13] See, *e.g.*, *United States* v. *Pollack*, CR 67-178 S (N.D. Alabama), SEC Lit. Rel. Nos. 3750, 4021 and 4300, affirmed, 417 F. 2d 240 (C.A. 5) (*per curiam*); *United States* v. *Duncan*, A-110-69 CR (D. Alaska), SEC Lit. Rel. No. 4538; *United States* v. *Zimmerman*, 71-231-CR (S.D. Fla.), SEC Lit. Rel. No. 4996. Similar factual allegations have been raised in other actions. See, *e.g.*, *Securities and Exchange Commission* v. *National Securities, Inc.*, 393 U.S. 453, 455; cf. *Herpich* v. *Wallace*, 430 F. 2d 792, 798 (C.A. 5). There have been other situations in which a state insurance commissioner has sought to apply the federal securities laws to transactions of the kind here involved. See, *e.g.*, *Ottosen* v. *Kaymac Indus., Inc.*, Civ. No. 407-69 (D. Utah).

ARGUMENT

SECTION 10(b) OF THE SECURITIES EXCHANGE ACT AND RULE 10b-5 THEREUNDER PROHIBIT A FRAUDULENT SCHEME THROUGH WHICH CORPORATE INSIDERS INDUCE A CORPORATION TO SELL ITS PORTFOLIO SECURITIES BY MISREPRESENTING THAT THE PROCEEDS OF THE SALE WILL BE RETURNED TO THE CORPORATION.

A. Introduction and summary.

The central question this brief discusses is whether there exists a relationship between the January 24, 1962, sale of Manhattan's government bonds and fraudulent conduct for which any or all of the respondents can be held responsible under federal securities law. The court of appeals assumed, for purpose of a motion to dismiss, that that sale was induced by misrepresentations about the use to be made of the proceeds. The sale generated funds equal to the fair market value of the securities sold, and thus caused no injury either to the actual purchaser, or to hypothetical potential purchasers, members of the investing public. Those funds, however, were not paid to Manhattan or invested for its benefit, as had been promised. Rather, the proceeds were applied to cover the purchase of Manhattan's stock by some of the defendants. Thus, the seller, Manhattan, did not receive the value for the securities sold which it had been fraudulently assured it would receive.

The issue is whether this alleged "deceptive device or contrivance" was "use[d] or employ[ed] in connection with the purchase or sale of any security"

within the meaning of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), as implemented by Securities and Exchange Commission Rule 10b-5, 17 C.F.R. 240.10b-5.

There can be no real dispute whether this language is susceptible of a construction which would make it applicable to the assumed facts. A fraudulent promise that value will be received if securities are sold —even though that promise is not one about the value of the securities themselves—can readily be characterized as a fraud employed "in connection with" the sale of a security. Rather, the dispute is whether the language should be given such a construction.

As an initial proposition, the legislative history of Section 10(b) makes plain that neither it, nor Rule 10b-5 which implements it, are to be narrowly construed. The "in connection with" clause, in particular, "is plainly and—one must assume—intentionally the loosest linkage, in any of the federal antifraud provisions, between a proscribed act and a security transaction." Bromberg, *Securities Law: Fraud— SEC Rule 10b-5*, Sec. 7.6(1), p. 190.21 (1969). Even narrowly viewed, there is more than a loose link here between the alleged fraud and Manhattan's sale of its government bonds; that sale was directly premised on the misrepresentation made to its board of directors regarding the use to be made of the proceeds of sale. More importantly, however, the alleged scheme must be viewed as a whole, of which the sale of Manhattan's government bonds was an integral part; the court of appeals' opinion is in-

fected with a formalistic and self-contradictory disregard for the transaction as a whole. By Section 10(b), Congress sought to protect all securities investors, including corporations such as Manhattan, from all forms of securities fraud. Manhattan, as an investor, was injured by a course of events, permeated by fraud, which resulted in its loss of its government bonds without return, in any form, of the promised equal value.

B. Inducing an investor, Manhattan, to sell its securities as part of a fraudulent scheme to transfer control and strip it of its assets, upon the explicit misrepresentation that the securities would be sold and the proceeds reinvested for its benefit, constitutes a fraud perpetrated "in connection with" that sale for the purposes of Section 10(b) and Rule 10b-5.

1. Section 10(b) must be interpreted broadly to effectuate its regulatory purposes.

Although we have found no specific legislative history concerning the "in connection with" phrase, the history of Section 10(b) makes clear that that phrase should be given a broad rather than a narrow reading. The Securities Exchange Act of 1934 was enacted in response to "the speculative orgy of 1928 and 1929" [14] and a presidential call for securities "legislation [which] has teeth in it." [15] Congress sought "to protect the interests of the public against the predatory

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[14] S. Rep. No. 1455, 73d Cong., 2d Sess., 81 (1934).

[15] H.R. Rep. No. 1383, 73d Cong., 2d Sess., 2 (1934).

operations of directors, officers, and principal stockholders of corporations * * *." [16]

Necessarily, it recognized that "[s]peculation, manipulation, * * * investors' ignorance and disregard of trust relationships by those whom the law should regard as fiduciaries" were "all a single seamless web," [17] and the Act's remedial provisions would have to be equally complementary. "No one of these evils can be isolated for cure of itself alone." [18] Thus, while the Act was intended to cover "a wide field," [19] Congress understood that it itself could not, by specifying or cataloguing unlawful conduct, effectively prohibit all forms of practices which "for some purposes may be turned to illegitimate and fraudulent means." [20] Accordingly it vested "broad discretionary powers in the [Securities and Exchange Commission.]" [21]

This discretion was embodied in Section 10(b). As one of the draftsmen described an earlier version (then Section 9(c)) before the House Committee, the

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[16] S. Rep. No. 1455, 73d Cong., 2d Sess., 68 (1934).

[17] H.R. Rep. No. 1383, 73d Cong., 2d Sess., 6 (1934).

[18] *Ibid.*

[19] *Ibid.*

[20] *Id.* at 7.

[21] *Ibid.*, see also, 78 Cong. Rec. 7696 (1934) (Remarks of Rep. Rayburn). The Senate Committee viewed the Securities Act of 1933 and the Securities Exchange Act of 1934 as vesting "in the Securities and Exchange Commission jurisdiction over the source of and traffic in securities." S. Rep. No. 1455, 73d Cong., 2d Sess. 393 (1934).

section provided, in effect, "Thou shalt not devise any other cunning devices. * * * [S]ubsection (c) is a catch-all clause * * *."[22] Although representatives of the securities industry complained that this provision would give the Commission power to prohibit virtually anything,[23] Congress agreed upon the present language, which gives the Commission broad rule-making power to prohibit "*any* manipulative or deceptive device or contrivance," and omits a proposed limitation of the section solely to securities traded or listed on a national securities exchange.[24] There has been no change in Section 10(b) since its enactment.

The legislative purpose was broad; the wording of the section is correspondingly broad; and the scope of the rule adopted by the Commission to enforce it is intended to be equally broad. "It would have been difficult to frame the authority to prescribe regulations, in broader terms. Had Congress intended to limit this authority to regulations proscribing common-law fraud, it would probably have said so. We see no reason to go beyond the plain meaning of the word 'any,' indicating that the use of manipulative or deceptive devices or contrivances of whatever kind

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[22] *Hearings Before the House Committee on Interstate and Foreign Commerce on H.R. 7852 and 8720*, 73d Cong., 2d Sess. 115 (1934).

[23] *Id.* at 178, 208-209, 251, 258, 297, 305, 486; *Hearings Before the Senate Committee on Banking and Currency on S. Res. 84 (72d Cong.) and S. Res. 56 and 97 (73d Cong.)*, 73d Cong., 1st & 2d Sess. 6624, 6634, 6899, 6910, 6936-6938, 6988 (1933-1934).

[24] S. 3420, § 10(b), 73d Cong., 2d Sess. (1934) (emphasis supplied).

may be forbidden * * *." *Rekant* v. *Desser*, 425 F. 2d 872, 880 n. 15 (C.A. 5). See also, *McClure* v. *Borne Chemical Co.*, 292 F. 2d 824 (C.A. 3), certiorari denied, 368 U.S. 939.[25]

The particular function of the "in connection with" phrase is undoubtedly to restrict the application of Section 10(b) to securities transactions. Absent that phrase, the section would authorize the Commission to promulgate rules and regulations prohibiting all kinds of manipulative or deceptive devices whether or not securities transactions were involved. It does not follow, however, that the restriction is a stringent one. The "in connection with" clause "is plainly and —one must assume—intentionally the loosest linkage, in any of the federal antifraud provisions, between a proscribed act and a security transaction." Bromberg, *Securities Law: Fraud-SEC Rule 10b-5*, Sec. 7.6(1), p. 190.21 (1969). See, *e.g.*, *Herpich* v. *Wallace*, 430 F. 2d 792 (C.A. 5); *Kahan* v. *Rosenstiel*, 424 F. 2d 161, 172 (C.A. 3), certiorari denied *sub nom. Glen Alden Corp.* v. *Kahan*, 398 U.S. 950; *Hooper* v. *Mountain States Securities Corp.*, *supra*, 282 F. 2d 195 (C.A. 5), certiorari denied, 365 U.S. 814. The additional restriction placed on the rule by the court of appeals—that the fraud must affect the value which changes hands in the security trade itself—runs counter to the teaching of this Court that federal se-

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[25] The House Committee appraised the function of the Securities Exchange Act as an undertaking to "[advance] the law," by a "constant extension of the legal conception of a fiduciary relationship—a guarantee of 'straight shooting' * * *." H.R. Rep. No. 1383, 73d Cong., 2d Sess. 5 (1934).

curities legislation, " 'enacted for the purpose of avoiding frauds,' [should be construed] not technically and restrictively, but flexibly to effectuate its remedial purposes." *Securities and Exchange Commission* v. *Capital Gains Research Bureau, Inc.*, *supra*, 375 U.S. at 195 (footnote omitted); *Tcherepnin* v. *Knight*, *supra*, 389 U.S. at 336.

2. Whether the events alleged are considered narrowly, as a misrepresentation regarding the use to be made of the proceeds of a sale of securities, or more broadly, as a scheme or course of conduct involving misrepresentation, authorization of sale by the board of directors, sale, and misappropriation of the proceeds, they constitute fraudulent conduct "in connection with" the sale of Manhattan's government bonds.

The court of appeals recognized—as, indeed, it had to—that, on the allegations of the complaint, there had been a fraud committed against Manhattan as a result of which it was deprived of assets worth $5 million. This fraud may be viewed narrowly or broadly. In its narrowest aspect, it was a typical common-law type of fraud: a misrepresentation to Manhattan's board of directors that, upon sale of the Treasury bonds, they would be replaced by securities of equal value—a representation which induced the Board to authorize the sale of the bonds. Viewing the scheme more broadly—which is the courts' customary approach under the federal securities laws— the misrepresentation and authorization were integral to a course of conduct that culminated in the misappropriation of the proceeds and that amounted to a "scheme * * * to defraud" in violation of Rule 10b-5(1) and

a "course of business" that "operat[ed] as a fraud or deceit," in violation of Rule 10b-5(3). But, however the transaction is viewed, we submit that it took place "in connection with" the sale of a security, namely, Manhattan's bonds.

a. *Misrepresentation regarding the use to be made of the proceeds of a sale of securities constitutes fraudulent conduct "in connection with" that sale.*

The court of appeals recognized that it was required to assume that Manhattan's board of directors had been deceived into making an investment decision which it would not otherwise have made. What it found significant was that the misrepresentation was not about the value of the securities to be sold, as such, but rather about the use to be made of the proceeds.

Numerous courts have held, however, that a misappropriation of funds resulting from a securities sale is within the purview of Section 10(b) and Rule 10b-5. See, *e.g.*, *Hooper* v. *Mountain States Securities Corp.*, *supra*.[26] In fact, almost since the Commission

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[26] Accord, *Securities and Exchange Commission* v. *Federal Shopping Way*, Civ. Action No. 7351 (W.D. Wash.), affirmed, 433 F. 2d 148 (C.A. 9); *Securities and Exchange Commission* v. *Bowler*, 427 F. 2d 190 (C.A. 4); *Allico National Corp.* v. *Amalgamated Meat Cutters & Butcher Workmen*, 397 F. 2d 727, 730 (C.A. 7); *Los Angeles Tr. D. & M. Exch.* v. *Securities and Exchange Commission*, 285 F. 2d 162 (C.A. 9), certiorari denied, 336 U.S. 919; *Stevens* v. *Vowell*, 343 F. 2d 374 (C.A. 10); *United States* v. *Monjar*, 147 F. 2d 916 (C.A. 3), certiorari denied, 325 U.S. 859; *Puharich* v. *Borders Electronics*

was established, application of the antifraud provisions of the Securities Act and the Securities Exchange Act to the misappropriation of investors' funds has been particularly prominent in its regulation of brokers and dealers registered with it. See, *e.g.*, *Securities and Exchange Commission* v. *Lawson*, 24 F. Supp. 360 (D. Md.).[27] Rule 10b-5(2)—which

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Co., Inc., supra, ['67-'69 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 92,141 (S.D.N.Y.) p. 96,651; *Goodman* v. *H. Hentz & Co.*, 265 F. Supp. 440 (N.D. Ill.); *Sinva, Inc.* v. *Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 253 F. Supp. 359, 367 (S.D. N.Y.); *Cooper* v. *North Jersey Trust Co.*, 226 F. Supp. 972, 978 (S.D. N.Y.).

[27] See also, *Securities and Exchange Commission* v. *Kelly*, ['48-'52 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 90,497 (N.D. Ill.); *Globe Securities Co., Ltd.*, 10 S.E.C. 1105; *D.S. Waddy & Co.*, 30 S.E.C. 367; *W.F. Coley & Co., 31 S.E.C.* 722; *Calvert Securities Corp.*, 35 S.E.C. 141. And see *Cooper* v. *North Jersey Trust Co., supra*, 226 F. Supp. at 978 ("such activity has been consistently viewed by the SEC as a violation of Section 10(b) and Rule 10b-5"). Compare *Norwegian Nitrogen Prods. Co.* v. *United States*, 288 U.S. 294, 315. While it could be urged that the special obligations of broker-dealers to their customers form the basis for the imposition of sanctions for conversion of a customer's securities (*see, e.g.*, Section 8 of the Securities Exchange Act, 15 U.S.C. 78h, and Rule 8c-1, thereunder, 17 C.F.R. 240.8c-1), such broker-dealer obligations are no more compelling than the obligations of insiders and controlling shareholders to their corporation. See, *e.g.*, *Pepper* v. *Litton*, 308 U.S. 295, 306-307; *Southern Pacific Co.* v. *Bogert*, 250 U.S. 483, 492; *Speed* v. *Transamerica Corp.*, 99 F. Supp. 808 (D. Del.). Moreover, in its administrative proceedings against broker-dealers growing out of the conversion of customers' securities, the Commission has generally alleged and found that such conduct constitutes a scheme to defraud and thus also violates the antifraud provisions of the federal securities laws. In light of the recent concern over brokerage house failures, it is important that no

broadly prohibits any misrepresentation or omission of a material fact—does not specify which material facts must be misrepresented or omitted before a cause of action for federal securities fraud arises; the rule speaks in terms of "any" untrue statements of material facts. By any standard, the failure of the defendants to disclose their intention to misappropriate the proceeds from the sale of Manhattan's portfolio securities and their misrepresentation that such proceeds would be used to purchase a certificate of deposit for Manhattan in a like amount were clearly material.[28] The presence of misrepresentations with respect to the investment value of the securities that are the subject of the securities transaction has never before been thought necessary, *Hooper* v. *Mountain States Securities Corp.*, *supra*, 282 F. 2d 195; *Errion* v. *Connell*, 236 F. 2d 447 (C.A. 9); *Stevens* v. *Vowell*, 343 F. 2d 374 (C.A. 10); cf. *Mills* v. *Electric Auto-Lite Co.*, *supra*, 396 U.S. at 381-382, not even by the Second Circuit. *A. T. Brod & Co.* v. *Perlow*, 375 F. 2d 393, 396-397 (C.A. 2).

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aspect of the Commission's enforcement arsenal be impaired. Cf. *Securities and Exchange Commission* v. *Charles Plohn & Co.*, 433 F. 2d 376 (C.A. 2); *Securities and Exchange Commission* v. *First Devonshire Corp.*, S.D. N.Y., 70 Civ. 3752; *Securities and Exchange Commission* v. *Robinson & Co.*, E.D. Pa., Civ. Action No. 70-2396.

[28] Materiality has been broadly defined as information a reasonable shareholder or investor "might have * * * considered important" in determining his course of action. See, *e.g.*, *Mills* v. *Electric Auto-Lite Co.*, *supra*, 396 U.S. at 384; Restatement (Second) of Torts Sec. 538(2)(a) (Tent. Draft No. 10, 1964); *Securities and Exchange Commission* v. *Texas Gulf Sulphur*, 401 F. 2d 833, 849, certiorari denied, 394 U.S. 976.

b. *The alleged sequence of events—misrepresentation, authorization of sale by the board of directors, sale, and misappropriation of proceeds—viewed as a whole demonstrates a fraud which occurred "in connection with" the sale of Manhattan's treasury bonds.*

While the previous analysis suffices to show the requisite connection, the Commission believes that the most serious deficiency in the court of appeals' opinion was in its effort to fragment the transaction by which Manhattan's securities were sold into several parts:

> [The fraudulent scheme's] sole object was to obtain possession of Manhattan's government bonds for the personal use of the perpetrators. * * * But that deception did not infect the subsequent sales transaction. With respect to the terms of the sale itself neither the purchaser nor the seller of the bonds was deceived or defrauded. * * * The fraud which harmed the plaintiff consisted of the failure of Sweeny and his associates to account for the proceeds. There is a structural difference between the sale of the corporation's bonds at a concededly fair price and the subsequent fraudulent misappropriation of the proceeds received. [App. 105a-106a].

Neither the overall scheme nor this transaction can be thus fragmented.

Contrary to the court of appeals' view, this is not the case of an individual who obtains possession of securities and then absconds. On the allegations, the deception of Manhattan continued long after possession of the bonds was obtained. Nor is this a case of a simple misappropriation of the proceeds of a sale

which, in itself, had not been fraudulently induced. Even such situations may involve a violation of the federal securities laws. But this case presents a unified scheme to defraud, with the sale of Manhattan's government securities at its center. Simply stated, the scheme was designed to pass control of Manhattan and its assets to some of the defendants at no cost to themselves, to make an improper distribution of funds to the prior owner, and to impose the cost of these activities exclusively on Manhattan.

The court's effort to chop this plan into separate fraudulent nonsecurities transactions and nonfraudulent securities transactions is analytically untenable even on its own terms. While the court speaks of a "*sole*" object of obtaining possession, which did not "infect the *subsequent* sales transaction," only a few lines later it characterizes the fraud as a failure merely "to account for the proceeds" and seeks to distinguish a sale at a fair price from a "*subsequent* fraudulent misappropriation." That the court cannot decide whether the fraud occurred before or after the "sale" is enough to show that the whole was one transaction, and that respondents' alleged fraudulent transaction cannot be denied "connection with" the sale of securities.

While Congress had no purpose to regulate transactions which comprise no more than internal corporate mismanagement, it sought to protect securities investors, including corporations such as Manhattan, from all forms of securities fraud. That corporate looting might be the motivating factor or the result

of a securities fraud is irrelevant. *McClure* v. *Borne Chemical Co., supra,* 292 F. 2d 824.[29] "The protection of one's investment once acquired is no less important than protection against acquiring an ill-advised investment." *United States* v. *Pope,* 189 F. Supp. 12, 23 (S.D. N.Y.). Enforcement actions instituted by the Commission have consistently borne out this philosophy.[30] Indeed, preserving the integrity of the securities markets was only one of the several aims of the Securities Exchange Act. With the exception of the decision below, the courts have recognized that in Section 10(b) Congress intended to prevent inequitable and unfair practices and to ensure fairness in securities transactions generally, whether conducted in the organized securities markets or face-to-face. *Matheson* v. *Armbrust,* 284 F. 2d 670, 674 (C.A. 9).[31]

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[29] See, *e.g., Rekant* v. *Desser,* 425 F. 2d 872, 878, n. 14; *Pappas* v. *Moss,* 393 F. 2d 865 (C.A. 3); *Dasho* v. *Susquehanna Corp.,* 380 F. 2d 262 (C.A. 7), certiorari denied *sub nom. Bard* v. *Dasho,* 389 U.S. 977; *Schoenbaum* v. *Firstbrook,* 405 F. 2d 215 (C.A. 2) (*en banc*), certiorari denied, *sub nom. Manley* v. *Schoenbaum,* 395 U.S. 906; *Herpich* v. *Wallace, supra.* But see, *Birnbaum* v. *Newport Steel Corp.,* 193 F. 2d 461, 464 (C.A. 2), certiorari denied, 343 U.S. 956.

[30] See, *e.g., Securities and Exchange Commission* v. *National Securities Inc., supra,* 393 U.S. at 455; *Securities and Exchange Commission* v. *Bowler, supra,* 427 F. 2d 190; *Securities and Exchange Commission* v. *Fifth Avenue Coach Lines,* 289 F. Supp. 3 (S.D.N.Y.), affirmed, 435 F. 2d 510 (C.A. 2); *Securities and Exchange Commission* v. *Parvin Dohrmann Co., et al.,* 69 Civ. 4543 (S.D.N.Y.), SEC Lit. Rel. Nos. 4441, 4459, 4475 and 4848, Securities and Exchange Commission, *Thirty-Sixth Annual Report* 109-110 (1970).

[31] See, *e.g., Herpich* v. *Wallace, supra,* 430 F. 2d at 806; *Rekant* v. *Desser, supra,* 425 F. 2d 872; *Kahan* v. *Rosenstiel,*

The Congress which recognized that "practices legitimate for some purposes may be turned to illegitimate and fraudulent means * * *"[32] could not have envisioned or countenanced such a formalistic and segmented approach as the courts below employed. See, *e.g.*, *Errion* v. *Connell*, 236 F. 2d 447, 453-454. (C.A. 9). That approach threatens to curtail the scope of fraud proscribed by the federal securities laws to narrowly-defined, definitely carved-out areas, and in the process, imperils the aspect of this legislation that has been, in large part, the key to its effectiveness—its far-reaching adaptability to unique and non-recurrent types of fraud, using as their base a securities transaction.[33]

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supra; Hooper v. *Mountain States Securities Corp., supra.* On prior occasions the Second Circuit has adopted this expansive approach to the purpose and coverage of Section 10 (b) and Rule 10b-5. See, *e.g.*, *Schoenbaum* v. *Firstbrook, supra,* 405 F. 2d 215; *Heit* v. *Weitzen,* 402 F. 2d 909 (C.A. 2), certiorari denied, 395 U.S. 903.

[32] H.R. Rep. No. 1383, 73d Cong., 2d Sess. 7 (1934).

[33] By the very language employed, the federal securities laws evidence a Congressional intent that they cover "[n]ovel or atypical" as well as "garden type variety" frauds. *A.T. Brod & Co.* v. *Perlow, supra,* 375 F. 2d at 397. As the court in *Columbia General Investment Corp.* v. *Securities and Exchange Commission,* 265 F. 2d 559, 564 (C.A. 5), noted:

> What form the deceit could or might take cannot be blueprinted. It is only certain that the measure of its skillfulness would be in proportion to the extent to which its confectors would give it the appearance of legality. One court has remarked, "The business of trading in securities is one in which opportunities for dishonesty are of constant recurrence and ever present. It engages acute, active minds, trained to quick apprehension, decision, and action." Archer v. S.E.C. 8 Cir., 1943, 133 F. 2d 795,

C. A corporate holder of securities, even though wholly owned by a single shareholder, is a "person" protected by Section 10(b) and Rule 10b-5.

Section 10(b), as implemented by Rule 10b-5 extends its protection [34] to "any person," a term defined by Section 3(a)(9) of the statute, 15 U.S.C. 78c(a)(9), to include "a corporation." Manhattan thus is protected against behavior which defrauds it "in con-

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803. This is but an elaboration of the brief, but pungent, expression of Judge Holmes for this Court in Wejss v. United States, 5 Cir., 1941, 122 F. 2d 675, 681, certiorari denied, 314 U.S. 687 * * *, that fraud is "as old as falsehood and as versable as human integrity." * * *

See also, *Securities and Exchange Commission* v. *Capital Gains Research Bureau, Inc., supra,* 375 U.S. at 193 n. 41.

[34] The existence of a private right of action for violation of Section 10(b) and Rule 10b-5, which respondents do not question, is firmly established. This Court has already held that a private right of action exists under the proxy provisions of the Act. *J.I. Case Co.* v. *Borak, supra,* 377 U.S. 426. Although it has never expressly decided whether a private right of action is similarly implied for violations of Section 10(b) and Rule 10b-5, it has upheld complaints based upon that right, without discussion of the question. *Surowitz* v. *Hilton Hotels Corp.*, 383 U.S. 363; *Tcherepnin* v. *Knight, supra,* 389 U.S. 332; cf. *Securities and Exchange Commission* v. *National Securities, Inc., supra,* 393 U.S. at 471 n. 4 (dissenting opinion of Mr. Justice Harlan). Each of the ten courts of appeals that has considered the issue has held that this remedy exists. *E.g., Janigan* v. *Taylor,* 344 F. 2d 781 (C.A. 1), certiorari denied, 382 U.S. 879; *Fischman* v. *Raytheon Mfg. Co.,* 188 F. 2d 783 (C.A. 2); *McClure* v. *Borne Chemical Co., supra,* 292 F. 2d 824 (C.A. 3); *Beury* v. *Beury,* 222 F. 2d 464 (C.A. 4); *Hooper* v. *Mountain States Securities Corp., supra,* 282 F. 2d 195 (C.A. 5); *Texas Continental Life Ins. Co.* v. *Dunne,* 307 F. 2d 242 (C.A. 6); *Jordan Bldg. Corp.* v. *Doyle, O'Connor & Co.,* 401 F. 2d 47 (C.A. 7); *Myzel* v. *Fields,* 386 F. 2d 718 (C.A. 8); *Ellis* v. *Carter,* 291 F. 2d 270 (C.A. 9), dismissal affirmed, 328 F. 2d 573 (C.A. 9); *Stevens* v. *Vowell,* 343 F. 2d 374 (C.A. 10).

nection with" any sale of its securities. *Hooper* v. *Mountain States Securities Corp., supra; Pettit* v. *American Stock Exchange*, 217 F. Supp. 21 (S.D. N.Y.). The contention is nonetheless made that because Manhattan's sole shareholder was a party to the fraud, it was a self-inflicted wound; the court of appeals believed that a defrauded corporation and its injured creditors and policyholders (as distinct from its shareholders) are not persons whom the Act protects (App. 107a).

Yet Congress in enacting Section 10(b) was acutely aware of the vulnerability of creditors of and policy holders in insurance companies to securities fraud perpetrated on those companies—which even then were large securities investors.[35] Whether such frauds

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[35] See H.R. Rep. No. 1383, 73d Cong., 2d Sess. 3-4 (1934), where the House Committee, after first cataloguing the impact that frauds and improper exchange practices then prevalent had, noted that "Over 15,000,000 individuals hold insurance policies, the value of which is dependent upon the security holdings of insurance companies." See also, 78 Cong. Rec. 7867, 7869 (1934) (Remarks of Rep. Maloney); S. Rep. No. 1455, 73d Cong., 2d Sess. 5 (1934):

> Transactions in securities on organized exchanges and over-the-counter markets are affected with a national public interest. * * * [T]he current value of securities held by * * * insurance companies * * * is dependent upon market quotations and consequently the welfare of countless individuals who have a financial interest in such institutions is directly affected by activities on the exchanges.

The magnitude of investments by insurance companies in "corporate stocks and corporate and Government bonds," then recognized by Congress (H.R. Rep. No. 1383, 73d Cong., 2d Sess. 3 (1934)), is many times greater today. See 2 Securities and Exchange Commission, *Institutional Investor Study Report*, H.R. Doc. No. 92-64, 92d Cong., 1st Sess. 778-780, 847-863 (1971).

were perpetrated by insiders or outsiders would hardly have been a matter of concern; it has long been recognized that for most purposes corporations have legal identities separate and apart from controlling shareholders and that such controlling shareholders owe a fiduciary loyalty to the corporation for the benefit of, among others, the creditors of the company; it is a loyalty which the corporation itself, or a trustee in the event of bankruptcy, may enforce. "For that standard of fiduciary obligation is designed for the protection of the entire community of interests in the corporation—creditors as well as stockholders." *Pepper* v. *Litton*, 308 U.S. 295, 306-307; *Hooper* v. *Mountain States Securities Corp.*, *supra*, 282 F. 2d at 203, 206.[36]

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[36] In *Hooper*, it was urged that in parting with $700,000 worth of treasury stock for worthless property, the corporation *qua* corporation had suffered no injury, that the only ones injured as a result of the transaction were the company's shareholders, and that the trustee (pursuing the cause of action on behalf of the bankrupt corporation) had no standing to litigate the matter for the stockholders who no longer could be deemed to have an interest in the company by virtue of its insolvency. As the court stated:

> Even in our remote position, we would be blind to all we hear and read about were we to succumb to the artificial contention that the issuance of this stock made the corporation no poorer * * *. Considering the purpose of this legislation, it would be unrealistic to say that a corporation having the capacity to acquire $700,000 worth of assets for its 700,000 shares of [treasury] stock has suffered no loss if what it gave up was $700,000 but what it got was zero. If—as we very much doubt—accountants would support any such contention as a consequence of the esoteric mysteries of the double entry system, * * *

Manhattan not only suffered an injury as a result of the fraudulent dealings in its government securities, it suffered that injury in its capacity as an investor.

> When a person who is dealing with a corporation in a securities transaction denies the corporation's directors access to material information known to him, the corporation is disabled from availing itself of an informed judgment on the part of its board regarding the merits of the transaction. In this situation the private right of action recognized under Rule 10b-5 is available as a remedy for the corporate disability. * * *

Shell v. *Hensley*, 430 F.2d 819, 827 (C.A. 5); *Herpich* v. *Wallace*, *supra* 430 F.2d at 809-810.

Enforcement of the federal securities laws has been particularly effective because it has generally been free of judicially-imposed artificial constraints on the applicability of the statutory provisions. Most of the decisions involving the provisions of those laws here under scrutiny have recognized Congress' broad aims and have followed this Court's instruction that they "make effective the Congressional purpose." *J.I. Case Co.* v. *Borak*, *supra*, 377 U.S. at 433-434. The decision of the court below, however, exalted form over substance and in so doing disregarded the caution ex-

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the law with its eye on reality would have to part company with such purists.

Id. at 203. See also *Rekant* v. *Desser*, *supra*; *Schoenbaum* v. *Firstbrook*, *supra*; *Pappas* v. *Moss*, *supra*; *Slavin* v. *Germantown Fire Ins. Co.*, 174 F. 2d 799, 805-806 (C.A. 3).

pressed by this Court that this is "an area where glib generalizations and unthinking abstractions are major occupational hazards." *Securities and Exchange Commission* v. *National Securities, Inc.*, *supra*, 393 U.S. at 465. Effective enforcement of the federal securities laws is dependent upon judicial willingness to interpret broadly the various antifraud and other statutory provisions therein. The decision below represents an unwarranted departure from this standard.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1971

No. 70-60

SUPERINTENDENT OF INSURANCE OF THE STATE OF NEW YORK, AS LIQUIDATOR OF MANHATTAN CASUALTY COMPANY,

Petitioner,

v.

BANKERS LIFE AND CASUALTY COMPANY, ET AL.,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR RESPONDENTS BELGIAN-AMERICAN BANKING CORPORATION AND BELGIAN-AMERICAN BANK & TRUST COMPANY

Preliminary Statement

This case presents the traditional elements of common law fraud involving the conversion of corporate funds. Such claims are cognizable in the New York courts where an action is now pending against all of the respondents here, but, we submit, no violation of the federal securities laws is involved.

Petitioner commenced his action under Section 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a), and conducted almost six years of discovery in an effort to support the sufficiency of his complaint. Only after petitioner

had completed his discovery and indicated his preparedness for trial did Belgian-American Banking Corporation ("Belgian-American Banking"), Belgian-American Bank & Trust Company ("Belgian-American Trust") and Bankers Life and Casualty Company ("Bankers Life") move in the district court to dismiss the complaint for failure to state a claim under the federal securities laws. (App. 48a) The district court (Herlands, J.), as did the court of appeals in affirming the district court's judgment, considered not only the allegations of the complaint but also petitioner's various unpleaded versions of the facts and concluded that the petitioner failed to state a federal claim under any federal law.

The district court declared that "the complaint, taken as a whole, alleges no more than a common law action for misappropriation of corporate funds by a fiduciary, embezzlement or fraudulent conveyance perhaps, or the distribution of an illegal dividend" (App. 84a), and held there was no federal jurisdiction under either the Securities Act of 1933 or the Securities Exchange Act of 1934. Chief Judge Ryan, in granting identical motions before him by the other respondents (App. 47a, 49a), adopted the opinion of Judge Herlands and concluded that the "fraud alleged was not in the purchase or sale of securities; but was waste of Manhattan's assets by diversion and misappropriation of its securities". (App. 89a) The dismissals were without prejudice to the prosecution of petitioner's pending action in the New York Supreme Court. (App. 90a)

The court of appeals affirmed the judgments of the district court and noted that the alleged fraud "in no way affected either the securities markets or the investing public. No stockholders were defrauded, no investor injured.

The purity of the security transaction and the purity of the trading process were unsullied. There was no danger that the securities sold would be overvalued on reaching the public markets." (App. 107a) Petitioner's motions for rehearing and rehearing *in banc* were denied by the court of appeals on September 30, 1970. (App. 112a, 113a)

Questions Presented

1. Should the scope of Section 10(b) of the Securities Exchange Act of 1934 be extended to reach the conversion of the proceeds from the sale of a corporation's portfolio of Treasury bonds, when the converter is the corporation's sole stockholder and when the conversion has no conceivable effect on any investor, any security or any securities market?

2. Does a liquidator have standing to sue on a corporation's behalf under the Securities Exchange Act of 1934, when the corporation itself is barred from suit by reason of the participation and approval of its sole stockholder?

Statement of the Case

Petitioner's statement of facts, devoid of record citations, bears little resemblance to the complaint filed in this action. The issues before this Court arise from the allegations of the complaint as well as all the alleged "facts" which petitioner advanced in the district court as part of a proposed amended complaint claiming relief also under Section 27 of the Securities Exchange Act of 1934, 15 U.S.C. § 77aa, for violation of Section 10(b), 15 U.S.C. § 77j(b), and Securities and Exchange Commission Rule 10b-5, 17 C.F.R. 240.10b-5. Both district court judges and

the court of appeals extended to petitioner wide latitude and properly construed the complaint together with its proffered amendatory allegations as not stating any federal claim for relief.

Petitioner's claim, in essence, is that the individual defendants purchased all of the outstanding stock of Manhattan Casualty Company ("Manhattan") for $5,000,000 from Bankers Life, paying for the stock with the proceeds of the sale of United States Treasury bonds which they took from the treasury of Manhattan immediately after they got control. The steps taken were in brief as follows:

First, defendants Standish T. Bourne and James F. Begole agreed to purchase from Bankers Life all of the stock of Manhattan and on January 19, 1962, executed a contract with Bankers Life as seller and Begole as purchaser, providing for the sale of all of Manhattan's stock for $5,000,000. On January 24, 1962, a check of respondent Irving Trust Company ("Irving") in the amount of $5,000,000 was advanced by Irving and given to Bankers Life and, in exchange, all of the shares of Manhattan were given to Begole. (App. 98a)

On the same day, after gaining control of Manhattan, the individuals sold Treasury bonds from Manhattan's portfolio, realized $4,854,552.67 and credited this sum plus an additional $150,000 in the name of Manhattan at Irving. The $5,000,000 Irving check was then charged against this account. (App. 99a-100a)

In summary, Bourne and Begole then owned the stock of Manhattan, Bankers Life had received $5,000,000 and Manhattan's assets, having been used to purchase the Manhattan stock, had been reduced by $5,000,000. (App. 100a)

In order to conceal the above, petitioner charges that the individuals used the proceeds of a second Irving loan in the amount of $5,000,000 to purchase a certificate of deposit from Belgian-American Trust, assigned that certificate to another corporation (New England Note Corporation) controlled by them and then used the certificate as security for a loan from Belgian-American Banking to New England. The proceeds of this loan were then used to repay Irving, thus resulting in a complete "wash" transaction. Manhattan's books reflected only the sale of Treasury bonds and the purchase of a certificate of deposit, without reflecting that the proceeds of the sale of the bonds were used to repay Irving and that the certificate of deposit had been assigned to New England and then pledged to Belgian-American Banking. (App. 101a)

The loan and certificate were renewed to January 1963, when Belgian-American Banking refused to renew its loan, and the individuals arranged for substitute credit with another bank. (App. 101a)

In April 1963 the New York Insurance Department discovered the misappropriation of Manhattan's assets and the New York Supreme Court placed the company in liquidation. (App. 101a)

ARGUMENT

POINT I

Although the regulatory power of the Commission and the scope of Rule 10b-5 are to be flexibly interpreted, the provisions of Section 10(b) of the Securities Exchange Act must be appropriately limited by the scope of the protection intended by Congress and by the discretion of the courts in defining the implied liability they have created.

A. *Summary*

The purpose of the federal securities laws and regulations have in no way been impaired by reason of the decision of the court of appeals in this case. Indeed, we are involved here with an effort to extend Section 10(b) and Rule 10b-5 into areas never before reached by any reported case or contemplated by the Congress, *see* Boone and McGowan, *Standing to Sue Under SEC Rule 10b-5*, 49 Texas L. Rev. 617, 622 (1971), and to bring under the federal regulatory umbrella all cases of fraud in the internal management of state corporations whenever a securities transaction was even incidentally involved. The courts, having implied civil liability for violation of Section 10(b) and Rule 10b-5, should define and limit that liability consistent with the Congressional purpose.

Fraud in a securities transaction falls unquestionably within the prohibitions of Section 10(b). This was what Congress sought to outlaw by the securities legislation; nothing the Second Circuit has done here in any way impairs the fulfillment of that purpose.

But fraudulent activity in which a security transaction is peripherally involved has never been viewed as a federal securities law violation. *Pettit* v. *American Stock Exchange,* 217 F. Supp. 21 (S.D.N.Y. 1963). Here the application of Rule 10b-5 to the alleged embezzlement of Manhattan's assets should not turn upon whether the funds diverted were cash deposits or the proceeds of the sale of a portfolio security. The district court properly sought to interpret the broad language of Section 10(b) and Rule 10b-5 in the context of the legislative history and succinctly summarized the four principal categories of situations in which the courts have upheld such claims:

> "In order to sustain a complaint alleging fraud under section 10(b) of the 1934 Act, it must appear with reasonable clarity from the face of the complaint either (1) that a purchase or sale of securities is at the crux of a fraudulent scheme; or (2) that inducing a purchase or sale of securities is the object of a fraudulent scheme; or (3) that fraudulent statements, misstatements, or omissions are made in a manner which is reasonably calculated to influence the investing public, or are of the sort which the reasonable investing public might rely upon; or (4) that the trading process is abused through potential market manipulation or the spread of watered stock." (App. 82a)

Only very recently the Second Circuit again refused to extend Section 10(b) liability where it could not be shown to be "in connection with" a securities transaction, as the Act requires. *Drachman* v. *Harvey,* Dkt. No. 35077 (2d Cir. July 21, 1971). The court wrote:

> "In short, §10(b) liability arises only when the alleged fraud between the parties and/or alleged market manipulation or deception is intrinsic to the securities

transaction itself. Where this prerequisite is not met, as here, no federally cognizable interest exists, and the complaint must be dismissed." (Slip op. at 4401-02)

B. *The 1934 Act must be construed in light of the Congressional purpose.*

Section 10(b) must be construed against the background of what Congress was seeking to accomplish when the Act was enacted. This Court has itself emphasized the necessity of considering this section in its proper context. *Securities and Exchange Commission* v. *National Securities, Inc.*, 393 U.S. 453, 466 (1969).

The Securities Act of 1933 (15 U.S.C. § 77a, *et seq.*), enacted after the revelation of numerous stock swindles, focused primarily on disclosures required in the initial offering of securities to the public. From that law the public can today rely on the required periodic and annual reports by public corporations, upon the process of registering securities to be offered to the public, and upon the full disclosures required in prospectuses to be delivered in connection with distributions of securities to the public. The Securities Exchange Act of 1934 (15 U.S.C. § 78a, *et seq.*), enacted a year later, can be said to have been aimed primarily at the secondary markets, particularly emphasizing the necessity for full disclosure and fair dealing in the buying and selling of securities in the market. This Act created the Securities and Exchange Commission as a watchdog over the securities industry and contains numerous explicit prohibitions against market manipulation and deceit in purchasing and selling securities in those markets. Those sections in which specific remedies were given to private individuals under the Securities Exchange

Act have been similarly directed to those two facets of securities dealings: disclosure of material facts in the securities transaction and prohibitions against market manipulation. *See* Sections 9(e), 16(b) and 18(a) (15 U.S.C. §§ 78i(e), 78p(b) and 78r(a)).

Both Section 10(b) and the Commission's Rule, now having been accepted by the lower courts as forming the basis of civil liability, *see, e.g., Fischman* v. *Raytheon Mfg. Co.*, 188 F.2d 783 (2d Cir. 1951), must be applied broadly and flexibly, as the Commission properly urges, but such broad and flexible interpretation must be consistent with and in furtherance of the Congressional purpose. However desirable it might have been for Congress to outlaw all fraudulent activity in the management of corporations, it has not done so and Section 10(b) was not so intended. The state laws are fully effective in this area, *N. Y. Bus. Corp. Law* §§ 719, 720 (McKinney 1963), as are the state courts, *New York Credit Men's Adjustment Bureau, Inc.* v. *Weiss*, 305 N.Y. 1, 110 N.E.2d 397 (1953).

The conclusion that some limitations on the applicability of Rule 10b-5 exist is beyond dispute. It is fundamental, for example, that the Rule may not be applied to transactions not intended to be reached by Congress in enacting the statute that authorizes the Commission to promulgate the Rule. Although the legislative history of Section 10(b) and Rule 10b-5 is sparse, *see* Bromberg, *Securities Law: Fraud, SEC Rule 10b-5*, Sec. 2.2, (1970), the committee reports that are available indicate that manipulative practices affecting the market price of stock were the chief target of the legislation. *See, e.g.*, S. Rep. No. 792, 73d Cong., 2d Sess. 7-8 (1934), which states:

> "Among such practices are fictitious or 'wash' sales; 'matched' orders, or orders for the purchase and sale of the same security emanating from a common source for the purpose of recording operations on the tape and thereby creating a false appearance of activity; and other transactions specifically designed to manipulate the price of a security."

Congress directed this remedial legislation, not to bring corporate fraud cases into the federal court, but to protect the trading process and the securities market and to protect the investing public from fraud in securities trading. The Second Circuit wrote:

> "The dominant congressional purposes underlying the Securities Exchange Act of 1934 were to promote free and open public securities markets and to protect the investing public from suffering inequities in trading . . . ." *Securities and Exchange Commission* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 858 (2d Cir. 1968), *cert. denied sub nom. Coates* v. *Securities and Exchange Commission*, 394 U.S. 976 (1969).

Furthermore, the Fifth Circuit wrote even more recently:

> "By section 10(b) Congress meant to prevent manipulation and control of the prices at which securities are bought and sold and to enable buyers, sellers, and traders of securities to make a proper appraisal of the value of securities." *Herpich* v. *Wallace*, 430 F.2d 792, 801 (5th Cir. 1970).

See Boone and McGowan, *Standing to Sue Under SEC Rule 10b-5*, 49 Texas L. Rev. 617, 622 (1971).

The Securities Exchange Act of 1934 was, after all, an Act "To provide for the regulation of securities exchanges and of over-the-counter markets operating in interstate

and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets, and for other purposes", 48 Stat. 881 (1934). *See also* S.Rep. No. 1455, 73d Cong., 2d Sess. (1934); § 2 of the 1934 Act, 15 U.S.C. § 78b.

The provisions of the 1934 Act itself also indicate that there should be some restraint. In the first place, the Act is a criminal statute, § 32, 15 U.S.C. § 78ff, and as such was originally intended to be strictly construed. Second, Congress made clear distinctions among the several sections of the Act. The typical structure was to proscribe certain activities prevalent in the trading markets with the words: "it shall be unlawful . . . .", §§ 5; 7(c), (d); 8; 10; 11(b), (d); 12(a); 14. When the Congress intended that civil liability attach to violations of its proscriptions in other sections, it made that purpose quite clear, §§ 9(e), 16(b), 18(a). Specifically, "when Congress intended to protect the stockholders of a corporation against a breach of fiduciary duty by corporate insiders, it left no doubt as to its meaning", *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461, 464 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952), referring to § 16(b).

C. *The Courts have implied a private remedy under Section 10(b) and should limit that remedy consistent with the Congressional intent.*

Even with respect to those provisions of the 1934 Act as to which the lower courts have implied private remedies, those courts have consistently attempted to articulate limitations on the scope of the Securities Exchange Act to avoid a construction which could sweep within the exclusive federal jurisdiction all questions of corporate

affairs. *See, e.g., O'Neill* v. *Maytag,* 339 F.2d 764 (2d Cir. 1964), in which the court focused on whether full disclosure had been accomplished with respect to the stockholders; finding that such disclosure existed, the court refused to hold that a question of corporate mismanagement was sufficient to bring the conduct within the scope of the Securities Exchange Act.

Whether the policy analysis has been stated in terms of the effect on investors or the securities markets, as was done in this case and has been done in other cases, *see, e.g., O'Neill* v. *Maytag, supra; Drachman* v. *Harvey, supra; Securities and Exchange Commission* v. *Texas Gulf Sulphur Co., supra,* or has taken the form of imposing limitations on standing, either with notions of "privity", *Joseph* v. *Farnsworth Radio & Television Corp.,* 198 F.2d 883 (2d Cir. 1952), or with the purchaser and seller requirement, *Birnbaum* v. *Newport Steel Corp., supra,* it has been universally recognized that Rule 10b-5 must be read in light of the Congressional purpose sought to be achieved. That purpose is not frustrated by the decisions below in this case.

This Court and the courts of appeal have been diligent in effectuating the Congressional purpose in enacting the Securities Exchange Act, *J. I. Case* v. *Borak,* 377 U.S. 426, 433 (1964); *Fischman* v. *Raytheon Mfg. Co., supra.* However, the courts have also recognized that an overbroad interpretation of Rule 10b-5 will destroy its effectiveness.

> "Considered alone, the sweeping language of Rule 10b-5 creates an almost completely undefined liability . . . . Without further delineation, civil liability is formless,

and the area of proscribed activity could become so great that the beneficial aspects of the rule would not warrant proscription." *Herpich* v. *Wallace, supra,* 430 F.2d at 804.

Since the courts originated the concept of implied civil liability under the Exchange Act, it is for the courts to "construct workable limits to liability under section 10(b) and Rule 10b-5 which will accommodate the interests of investors, the business community, and the public generally." *Herpich* v. *Wallace, supra,* 430 F.2d at 805.

This is not to imply that the creation by the lower courts of implied civil liability was incorrect. The time for that argument has presumably long since passed. It does clearly indicate, however, that it is appropriate for the judiciary to impose workable limitations on the statute and its underlying rule when they were clearly intended to be limited. The expansion of remedies under the Act was found necessary to effectuate the intent of Congress in enacting certain provisions of the 1934 Act. Granted that the courts had the duty to create new remedies to effectuate the legislative intent, the courts have the additional responsibility to ensure that their creativity not be applied in situations remote from that intent, thereby destroying Rule 10b-5 as a workable means of policing the securities market.

D. ***The court of appeals here, responsive to the Congressional purpose and consistent with all prior reported decisions under the 1934 Act, correctly refused to find a federal cause of action.***

Petitioner and the Commission are asking this Court to extend the scope of Section 10(b) into areas never before reached. The Commission seizes on the sale of Manhattan's

Treasury bonds[1]—a sale made on the open market for a full and adequate consideration—as support for its contention that the embezzlement of the proceeds is a federal cause of action, although such embezzlement had no effect on any security, the investment value of any security or any of the securities markets. Such conduct was not what Congress had in mind; no other court has so extended the Act; and, indeed, it is not a subject with which the Commission should even concern itself.

The language of Section 10(b) and the seemingly unlimited language of Rule 10b-5 should not be read in a vacuum. They must be read with an understanding of the purpose for which they were created. All of the decisions relied upon by the petitioner and the Commission properly reflect an appreciation of the basic Congressional purpose to protect the securities markets and the investing public and find securities fraud only in that context. This is precisely the approach properly taken by the courts below.

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[1] No claim under Rule 10b-5 can be made with respect to the certificate of deposit because that certificate was not a "security" as defined in Section 3(a)(10) of the Securities Exchange Act of 1934. Section 3(a)(10) defines "security" in general terms, but specifically excludes "any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months * * * *" A certificate of deposit for cash, representing as it does only a negotiable time note, draft, or bill of exchange, is necessarily excluded from the definition of "security".

The definition does mention a "certificate of deposit, for a security", which is intended to refer to certificates which reflect an interest in equity securities deposited with a bank. For example, reorganization trustees have on occasion deposited securities with a bank, and issued participation certificates; similarly, certain banks have issued certificates reflecting an interest in securities held abroad, in bearer form, commonly known as American Depositary Receipts. Congress obviously intended to include certificates which reflect an interest in securities within the definition of "securities" under the Securities Exchange Act. *See* Loss, *Securities Regulation*, 460-65, 795-96 (2d ed. 1961 and 1969 supp.).

The first real attempt at reconciling the Congressional intent with the needs of investors, the business community, and the public at large was the Second Circuit's decision in *Birnbaum* v. *Newport Steel Corp., supra.* There, the defendant—president of Newport Steel Corporation sold his control stock at a premium to a second corporation interested in securing a captive supply of steel during a shortage. The defendant had previously broken off negotiations with a third corporation concerning a merger which would have been beneficial to all the shareholders of the corporation. Plaintiffs, suing derivatively and as representatives of the other minority shareholders, alleged a violation of fiduciary duty and also alleged fraud in connection with certain letters sent out to the minority shareholders by the corporation's president during the merger negotiations. The court adopted the analysis of *Fischman* v. *Raytheon Mfg. Co., supra,* and of SEC Release No. 3230, dated May 21, 1942, that Rule 10b-5 was adopted solely to close the loophole left by the absence of an equivalent of § 17 of the Securities Act as a remedy for defrauded sellers of securities. The Commission only intended to make the same prohibitions applicable to both buyers and sellers, a purpose made clear by the similarity of the language used. Aware of the ability of Congress when it so intends to protect shareholders against breaches of fiduciary duty, § 16(b), 15 U.S.C. § 78p(b), the court reasoned:

> "The absence of a similar provision in Section 10(b) strengthens the conclusion that that section was directed solely at that type of misrepresentation or fraudulent practice usually associated with the sale or purchase of securities rather than at fraudulent mismanagement of corporate affairs, and that Rule X-10B-5 extended protection only to the defrauded purchaser or seller." 193 F.2d at 464

This purchaser-seller requirement, adopted by every circuit which has considered it,[2] has been liberally interpreted by the courts to accommodate the novel forms of fraud referred to in *A. T. Brod & Co.* v. *Perlow*, 375 F.2d 393 (2d Cir. 1967). *See also Crane Co.* v. *Westinghouse Air Brake Co.*, 419 F.2d 787 (2d Cir. 1969), *cert. denied*, 400 U.S. 822 (1970). The Commission contends that this expansion has not been broad enough and that this requirement should now be abolished, but agrees with these respondents that this case does not present a proper vehicle for review of that holding since Manhattan was a seller of the Treasury bonds. (Br., at 7, n. 6)[3] The long established purchaser-seller requirement effectively carries out the Congressional intent in limiting the scope of the rule to fraud in transactions affecting securities.

The Commission objects to the refusal of the courts below to consider the sale of securities and the fraud per-

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[2] *Iroquois Industries, Inc.* v. *Syracuse China Corp.*, 417 F.2d 963 (2d Cir. 1969), *cert. denied*, 399 U.S. 909 (1970); *Greenstein* v. *Paul*, 400 F.2d 580 (2d Cir. 1968); *Herpich* v. *Wallace*, 430 F.2d 792 (5th Cir. 1970); *Mader* v. *Armel*, 402 F.2d 158 (6th Cir. 1968), *cert. denied sub nom. Young* v. *Mader*, 394 U.S. 930 (1969); *Dasho* v. *Susquehanna Corp.*, 380 F.2d 262 (7th Cir.), *cert. denied sub nom. Bard* v. *Dasho*, 389 U.S. 977 (1967); *Greater Iowa Corp.* v. *McLendon*, 378 F.2d 783 (8th Cir. 1967); and *Erling* v. *Powell*, 429 F.2d 795 (8th Cir. 1970).

[3] Although the petitioner does not claim to be suing on behalf of creditors or policy holders and does not even allege that there are any, the Commission asserts that the petitioner here should nevertheless be permitted to sue on behalf of "the creditors of the company". (Br., at 28) As pointed out in Point II below, creditors have no standing to sue under the 1934 Act, and the reasoning of the Second Circuit in *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952), and the other courts following it support the creditors' lack of standing. But since this is not a creditor's case, *Birnbaum* is not involved.

petrated as two parts of the same transaction. The lower courts realized that there had been a securities transaction —the Government bonds had been sold out of Manhattan's portfolio, but at a price that was concededly fair. They also realized that the assets of Manhattan had been misappropriated. But the lower courts concluded correctly that these were separate actions. The essence of the plan was the misappropriation of the assets of the corporation. The fact that the misappropriation involved the proceeds of the sale of securities does not change the basic form of the transaction. If the individual defendants removed the bonds from Manhattan's vault, sold them and absconded with the proceeds, there would have been no 10b-5 violation within the Congressional intent. The fact that they sold the securities first and then converted the proceeds should not change this result. "Rule 10b-5 was not intended to provide a remedy for schemes amounting to no more than 'fraudulent mismanagement of corporate affairs'", *Superintendent of Insurance of the State of New York* v. *Bankers Life and Casualty Co.*, (106a), quoting in part *Birnbaum* v. *Newport Steel Corp., supra* at 464.

The complaint here was not dismissed because Manhattan was neither a purchaser nor a seller, nor was it dismissed because Manhattan was not deceived. The conclusion of the lower courts was that the deceit in no conceivable way could affect the persons or the markets or the purposes intended to be protected or effectuated by the Congress in passing Section 10(b) and authorizing Rule 10b-5.

> "The fraud alleged in this case in no way affected either the securities market or the investing public. No stockholders were defrauded, no investor injured. The purity of the security transaction and the purity of

the trading process were unsullied. There was no danger that the securities sold would be overvalued on reaching the public markets." (App. 107a)

If such fraud were taken to be within the scope of Rule 10b-5, then the Rule itself is outside the mandate of Congress and is void. An examination of the cases since *Birnbaum* reveals that the courts have invoked a simple test of whether the transaction involved comes within the scope of Congressional intent. *Crane Co.* v. *Westinghouse Air Brake Co., supra* at 798.

Although actionable under state law, common law fraud for all types of corporate mismanagement is not proscribed by federal securities laws, *Iroquois Industries, Inc.* v. *Syracuse China Corporation,* 417 F.2d 963 (2d Cir. 1969), *cert. denied,* 399 U.S. 909 (1970); *Mutual Shares Corporation* v. *Genesco, Inc.,* 384 F.2d 540 (2d Cir. 1967). The question presented here is to what extent the securities markets must be involved to warrant application of federal sanctions to a fraudulent practice. Actions under § 10(b) and Rule 10b-5 will not be sustained where "purchase or the sale of securities . . . is only incidental to a major mismanagement issue," *Pettit* v. *American Stock Exchange, supra. See Lester* v. *Preco Industries, Inc.,* 282 F. Supp. 459 (S.D.N.Y. 1965); *Kaminsky* v. *Abrams,* 281 F. Supp. 501 (S.D.N.Y. 1968). The issue in each case is whether or not defendants' alleged misconduct is so closely involved with the securities trading process that it falls within the ambit of the 1934 Act, making federal jurisdiction appropriate. Every decision cited by the Commission focuses upon the nature of the effect of the alleged misconduct upon the securities market or investors.

In *Hooper* v. *Mountain States Securities Corporation,* 282 F.2d 195 (5th Cir. 1960), *cert. denied,* 365 U.S. 814

(1961), a trustee in bankruptcy brought an action under § 10(b) and Rule 10b-5 on behalf of Consolidated American Industries, the bankrupt. The former secretary and former general counsel of Consolidated had written fraudulent letters to Consolidated's transfer agent to deceive him into believing that he could appropriately issue 700,000 shares of stock, valued on the market at about $1 per share. In return for various rights valued at about $40,000, the shares were issued to Mid-Atlantic Development Company, a creature of the conspirators that had already been dissolved. The shares were ultimately distributed to the individual conspirators, and over 400,000 shares were sold in turn to unknowing investors on the market.

In finding a cause of action under Rule 10b-5, the court pointed out that the persons sought to be protected by the Act were those engaged in buying and selling and trading in corporate securities. Moreover, the issuance of 400,000 and more shares of watered stock to public investors was precisely the kind of abuse that Congress sought to proscribe. *Ruckle* v. *Roto American Corporation,* 339 F.2d 24, 28 (2d Cir. 1964).

In *A.T. Brod & Co.* v. *Perlow, supra* at 393, plaintiff broker received orders to buy certain securities from defendants. After observing that the securities had failed to rise in value by the settlement date, the defendants refused to pay. The orders had been placed and the securities traded on the New York Stock Exchange. In finding a valid cause of action under the securities laws, the court emphasized the impact on the trading process and noted that the

> "artificial demand created by purchasing securities which are not to be paid for unless the market value

of the stock rises, can have an unsettling and potentially manipulative effect upon the securities market —contrary to the very purpose of the Act." 375 F.2d at 397.

In *Schoenbaum* v. *Firstbrook*, 405 F.2d 215 (2d Cir. 1968), *cert. denied sub nom. Manley* v. *Schoenbaum*, 395 U.S. 906 (1969), the original three-judge panel, 405 F.2d 200, found that a corporation could bring a Rule 10b-5 action where it had been deceived as to investment value. The entire court, in agreement on that point, found that if the transaction involved deception of the minority shareholders by diluting their shares through the issuance of treasury stock for less than fair value, a good cause of action had been stated.

Crane Company v. *Westinghouse Air Brake Company*, 419 F.2d 787 (2d Cir.), *cert. denied*, 400 U.S. 822 (1970) presented a classic example of judicial willingness to apply Rule 10b-5 where the court found a dramatic effect on the market. Crane sought to take over Air Brake, much to the concern of Air Brake's management and American Standard, Crane's chief competitor. Crane made a tender offer for Air Brake's shares, offering $50 in stock and debentures up to a certain date. Around the same time, Standard and Air Brake announced plans to merge, the plan being to exchange Air Brake common stock for a new Standard preferred stock. Standard bought large quantities of Air Brake common on the Exchange, including huge blocks of shares on the last day of Crane's tender offer. These Standard purchases were made at increasingly higher prices—up to $50 per share—during that last day which would give the impression to the average investor watching the trading on the Exchange that the Air Brake shares

would be worth more than the $50 Crane was offering. At the same time, Standard sold large blocks of Air Brake stock privately off the Exchange at a substantial loss. "Standard's extraordinary buying here, coupled with its large secret sales off the market, inevitably distorted the market picture and deceived public investors," 419 F.2d at 793. The *Crane* court found that "[T]he purpose of Congress in enacting sections 9(a)(2) and 10(b) was to *protect the investing public from manipulation and deception by the use of devices which defrauded or misled investors in securities transactions*" (emphasis added), 419 F.2d at 798, and quoted with approval the thrust of its earlier decision in *Securities and Exchange Commission* v. *Texas Gulf Sulphur Co., supra* at 860:

> "[The phrase 'in connection with the purchase or sale of any security'] intended only that the device employed . . . be of a sort that would cause reasonable investors to rely thereon, and, in connection therewith, so relying, cause them to purchase or sell a corporation's securities."

See Kahan v. *Rosenstiel,* 424 F.2d 161 (3d Cir.), *cert. denied sub nom. Glen Alden Corp.* v. *Kahan,* 398 U.S. 950 (1970); *Herpich* v. *Wallace, supra; Marino* v. *Coburn Corp.,* CCH Fed. Sec. L. Rep. ¶ 92,959 (E.D.N.Y. February 19, 1971) at p. 90,542.

Each of these decisions emphasizes that the evil Congress sought to avoid was the deception of investors, typically centering on the value of the security in question. The Commission in its brief (at 21) criticizes the court of appeals' decision for finding no cause of action because there was no deception as to investment value. The Commission points out that the opinion in *A. T. Brod & Co.* v. *Perlow, supra,* decided that Rule 10b-5 was not meant to

deal only with fraud as to the investment value of securities, citing *Hooper* v. *Mountain States Securities Corporation, supra.* This misses the point. In both *A. T. Brod* and *Hooper,* the plaintiff suffered a loss because the value received was less than the value given. In *A. T. Brod,* the broker did not receive the sales price of the securities ordered and he was forced to sell at a loss; in *Hooper* stock worth $700,000 was exchanged for rights worth much less. The court of appeals meant only that there was no claim that equal value was not received in the sale of Manhattan's Treasury bonds. Therefore, since there was no harm at that point, no investor, *e. g.,* in Government bonds, could have been injured. The court went on to find that the harm occurred at a subsequent point—the misappropriation of the proceeds. This act of mismanagement, determined to be a separate act with independent legal significance, does not give rise to a claim for securities fraud, because it only involved a closed corporation and had no effect on the securities markets or investors.

The heart of the Commission's position seems to attack the separation of the fraud from the securities transaction by the courts below, yet this fraud would not come under the federal securities laws even if this were to be viewed as a unified transaction. The only security in which there was any public or private market—the Treasury bonds—traded at a concededly fair price. The only possible detriment caused by the entire transaction—even considered as a unitary transaction—was an embezzlement loss suffered by Manhattan. Under the peculiar facts of this case, not even this loss is within the intent of Congress in passing the 1934 Act. There was no public market in the stock—the shares were not traded on any regulated exchange or over-

the-counter. There was not even a private market in the stock—100% ownership has always rested with a single corporation. As the court of appeals put it, "the purity of the security transaction and the purity of the trading process were unsullied." (107a)

Finally, the principal architect of the loss to the corporation was the *sole* owner of the corporation. Any loss realized by the corporate shareholder was self-inflicted; the only conceivable loss would be to the creditors of Manhattan, when it was later liquidated, but no loss to creditors is even alleged in the complaint and, in any event, that loss would be peculiarly the concern of New York law, and would be determined by New York courts.

In *Schoenbaum* v. *Firstbrook, supra,* there were minority shareholders injured by such deception. But not even *Schoenbaum* can be stretched to deal with the unique situation here, namely, that the sole shareholder being defrauded was also the alleged leader of the conspiracy.

Since the sole stockholder could not conceivably have been deceived, the petitioner is left with the argument that the insider who sold the bonds implied a promise not to misappropriate them or their proceeds. An analogous argument was presented to the Second Circuit in *Mutual Shares Corporation* v. *Genesco, Inc.,* 384 F.2d 540 (2d Cir. 1967) and rejected in part on the reasoning of the S.E.C.'s *amicus* brief.[4]

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[4] "The contention that plaintiffs were injured by defendants' failure to disclose their alleged intention, if they should obtain control of Kress, to misuse its assets and otherwise to mismanage Kress presents a somewhat more difficult question. It seems to us that plaintiffs' position in this regard, insofar as Rule 10b-5 is concerned, comes down to the proposition that defendants must be held to have impliedly represented, not only to Kress stockholders to whom their offers were addressed but to the world at large,

Finally, the Commission claims that "the failure of the defendants to disclose their intention to misappropriate the proceeds from the sale of Manhattan's portfolio securities and their misrepresentation that such proceeds would be used to purchase a certificate of deposit for Manhattan in a like amount were clearly material." (Br., at 21). But the Commission does not identify to whom defendants should have disclosed "their intention to misappropriate." The purchasers were not interested; they got full value for their money. Manhattan, the seller, must be charged with full knowledge through the participation of the sole stockholder.

In any event, just as the "implied representation" theory was properly rejected in *Genesco, supra,* because a contrary result would mean that any instance of corporate mismanagement would be turned into a securities law claim, so this analogous contention must be rejected here. The claim that Genesco failed to announce that it intended to divert the assets of Kress to its own pension fund is indistinguishable from the claim that the alleged conspirators here failed to reveal that they would convert the proceeds from the sale of the Treasury bonds.

In the instant case, there were no investors, no markets and no information withheld from any shareholder of

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that they would not mismanage Kress if they acquired control and that plaintiffs relied upon this implied representation when they purchased Kress shares after defendants had obtained control, and that consequently there was fraud on plaintiffs in connection with plaintiffs' purchases. We think this proposition is too broad. It would convert practically any instance of corporate mismanagement into a Rule 10b-5 case, since any shareholder could contend that at the time when he purchased the shares he relied on an implied representation by management that they would not mismanage." (S.E.C. Brief, at 6)

the corporation. In such circumstances, imposing liability under the federal securities laws would not effectuate Congressional intent or come within the legislative purpose. If the alleged conspirators had merely stolen money from the till of Manhattan there would be exactly the same absence of effect on the non-existent outside investors and the public market.

It was never intended that federal law should supersede state law relating to corporate mismanagement. *See Birnbaum* v. *Newport Steel Corp., supra; Lester* v. *Preco Industries, Inc., supra; Kaminsky* v. *Abrams, supra; Barnett* v. *Anaconda Company,* 238 F.Supp. 766, 770 (S.D.N.Y. 1965); and Loss, *Securities Regulation* 3870 (1969 Supp.).

The Fifth Circuit recently stated:

> "If Congress had intended that the federal courts inquire into every decision affecting the management of corporations and then fashion a new federal law superseding state law on the fiduciary responsibilities of corporate directors, officers, and controlling persons, presumably so revolutionary a federal intervention into an area traditionally handled by the states would have been clearly expressed." *Herpich* v. *Wallace, supra,* 430 F.2d at 809.

The same warning was sounded even more recently by the Second Circuit, which after all has dealt with most of the cases arising under Rule 10b-5, and which in the instant case denied rehearing *in banc*:

> "Even giving § 10(b) and Rule 10b-5 the most liberal construction, *i.e.*, that courts should not blind themselves to the fact that 'Congress' purpose in enacting § 10(b) of the Exchange Act was to protect the public by broadly prohibiting *all* fraudulent schemes in con-

nection with the purchase or sale of securities,' irrespective of their novelty or atypicality, nothing is to be found in the history of that legislation, or in subsequent discussions thereunder, to indicate that Congress was enacting securities legislation for the purpose of conferring jurisdiction on the federal courts over corporate mismanagement situations absent fraud intrinsic to the securities transaction itself, which is all that the facts of this case present. Appellants have their remedies in other forums for such misfeasance as there may have been." *Drachman* v. *Harvey, supra,* slip op. at 4403-04.

POINT II

Manhattan could not challenge the securities sale, nor can petitioner now sue on its behalf, since Manhattan's sole stockholder ordered the sale.

A. *Summary*

Petitioner and the Commission have constructed their legal theory around a claimed fraud on the Manhattan directors, ignoring the obvious fact that the directors could not possibly have any claim of their own and that any claim of Manhattan would be barred by the active participation and approval of its sole stockholder.

At least the Commission appreciates the predicament faced by petitioner and seeks to salvage the situation by asserting that the petitioner must really be suing for "injured creditors and policy-holders." (Br., at 27) This effort must also fail for two reasons: (1) Petitioner is not even purporting to sue for creditors (App. 4a), nor has he alleged that there are any; and (2) in any event, creditors have no standing under the federal securities laws to sue directly for an alleged fraudulent sale by the corporation.

B. *Manhattan has no claim, nor does petitioner as its liquidator.*

The essence of fraud is, of course, misrepresentation and deceit. Consequently Manhattan cannot be injured by any fraud when its sole stockholder (Begole) was aware of all the circumstances of the challenged sale and himself ordered the sale. *Old Dominion Copper Mining & Smelting Company* v. *Lewisohn,* 210 U.S. 206 (1908); *Field* v. *Lew,* 184 F. Supp. 23 (E.D.N.Y.), *aff'd sub nom. Field* v. *Bankers Trust Company,* 296 F.2d 109 (2d Cir. 1961), *cert. denied,* 369 U.S. 859 (1962). *See Schoenbaum* v. *Firstbrook, supra,* 405 F.2d at p. 220. To speak of fraud on directors in such circumstances is unrealistic and reflects the straining by petitioner to locate some nail, however precarious, on which to hang his federal theory.

Petitioner, as liquidator of Manhattan, stands in no greater position. He alleges that he is "vested with title to all property, contracts and rights of action of Manhattan" (Complaint, par. 2; App. 4a); it must follow that he is precluded from recovery by reason of the same defenses applicable to an identical suit by Manhattan itself.

> "A corporate officer who uses corporate funds for his own purposes may be liable for conversion to the corporation and in bankruptcy to the trustee. Since the officer had no title to the property, transferees of the officer may be similarly liable. However, the general rule of liability does not apply when the officer's acts have been ratified by all the shareholders of the corporation. In that case, the unauthorized acts of the individual become the authorized acts of the corporation, the corporation loses its right of action against the officer, and the corporation, having no right, the trustee in bankruptcy also has no right. (citing authorities) Under the facts of the instant case, the corporation would have no action in conversion

against Lew, any of his transferees, or any one participating in the transfer, because Lew as sole stockholder ratified his own actions." *Field* v. *Lew, supra,* 184 F. Supp. at 27.

A sole stockholder does not, of course, have unfettered discretion in the management of his corporation. He may, as the district court recognized, be held accountable in a proper context in a state court for the "distribution of an illegal dividend" or "fraudulent conveyance." (App. 84a) But in order to sustain a federal claim here, Manhattan must be shown to be a defrauded seller, which the active participation of its owner precludes.

Petitioner, as he has done throughout the case, responds to the above by silence. The Commission obviously appreciates the legal obstacle which makes this case atypical and seeks to solve the problem by referring to "injured creditors and policyholders." (Br., at 27)

But who are these "injured creditors and policyholders"? Petitioner does not purport to sue for them; he has not even alleged that there are any[5] or that Manhattan was even insolvent. He knows that such a claim would expose the truly non-federal nature of his case.

Even if this were a creditor's suit, a creditor (or representative on his behalf) properly has no standing to sue under the 1934 Act. A creditor is neither a seller nor a

[5] A recent decision of the Fifth Circuit, *Bailes* v. *Colonial Press, Inc.*, Dkt. No. 29048, (5th Cir. June 15, 1971), permitted a bankruptcy trustee to sue on behalf of a corporation defrauded into a stock sale by the corporation's promoters. The court did not analyze the standing question, legislative history or cite any authority for the trustee's right to sue. It is, however, different from the present case in that the corporation was bankrupt and had innocent stockholders who had subsequently purchased the corporation's stock.

purchaser of any security. *Birnbaum* v. *Newport Steel Corp., supra.* He may have claims against the corporation, its officers and directors and stockholders, but such claims arise out of state law (*e.g.,* fraudulent conveyance, illegal dividend, waste) and not "in connection with the purchase or sale of any security", 15 U.S.C. 78j(b).

The legislative history of the 1934 Act does not even suggest that creditors (or a representative on their behalf) have any standing to sue under any provision of the Act; the Court should not now in construing Section 10(b) extend the implied civil liability created by the courts to claims of creditors. There is no need to do so; state law is fully adequate.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted,

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August 31, 1971

IN THE

Supreme Court of the United States

October Term, 1970

No. 1159

SUPERINTENDENT OF INSURANCE OF THE STATE OF NEW YORK, as Liquidator of MANHATTAN CASUALTY COMPANY,

Petitioner;

against

BANKERS LIFE AND CASUALTY COMPANY, IRVING TRUST COMPANY, BELGIAN AMERICAN BANKING CORPORATION, BELGIAN AMERICAN BANK & TRUST COMPANY, GARVIN, BANTEL & COMPANY, GEORGE K. GARVIN,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR RESPONDENTS GARVIN, BANTEL & COMPANY and GEORGE K. GARVIN

PRELIMINARY STATEMENT

The preliminary statements set forth in the briefs submitted by respondents Belgian-American Banking Corporation and Belgian-American Bank and Trust Company and Irving Trust Company are hereby adopted by respondents Garvin, Bantel & Company and George K. Garvin.

QUESTIONS PRESENTED

The questions presented as set forth in the briefs of Belgian-American and Irving Trust are hereby adopted by respondents Garvin, Bantel and Garvin.

STATEMENT OF THE CASE

For the purpose of this appeal, the statements of the case set forth in the briefs of Belgian-American and Irving Trust are

acceptable to respondents Garvin, Bantel and Garvin and are hereby adopted.

Whether the securities in question were used by the defendants to repay Irving Trust for its five million dollar loan to purchase Manhattan Casualty, or whether the securities were used to create a certificate of deposit for five million dollars, which certificate was then pledged for a loan of five million dollars, makes no difference with respect to the critical issue presented by this case. Under either interpretation*, Manhattan Casualty's assets were converted and the question is whether that conversion constitutes a fraud in connection with a securities transaction. We submit that it is not.

*Respondent Irving Trust suggests in its brief that the wrongdoing might have occurred one year after the sale of Manhattan Casualty. This interpretation does not alter the main issue of this case as to whether the fraud was in connection with a securities transaction which violated the Securities Acts.

ARGUMENT

I

THE ARGUMENTS SET FORTH IN THE BRIEFS OF RESPONDENTS BELGIAN-AMERICAN AND IRVING TRUST ARE HEREBY ADOPTED BY RESPONDENTS GARVIN, BANTEL & GARVIN.

II

THE CONVERSION OF MANHATTAN CASUALTY'S ASSETS DID NOT CONSTITUTE A FRAUD UNDER THE SECURITIES EXCHANGE ACT OF 1934.

The notion expressed by petitioner and the Securities and Exchange Commission that tortious activity which involves securities in any way is the basis of a cognizable federal claim is simply incorrect. The Securities Acts were not intended as a cure-all for every type of corporate wrongdoing; rather, their provisions relate only to transactions which may adversely affect investors and the integrity of the public securities market. For a particular transaction to be the basis for an action under the Securities Acts, it must be alleged that there was deception, that the deception resulted in a wrong to the detriment of a person protected by the

Securities Acts, and that there was a causal relationship between the securities transaction and the wrong. In their attempt to establish the necessary link between the sale of Manhattan's bonds and the wrong, petitioner and the Commission rely on the allegation that the board of directors of Manhattan was deceived because it was not informed that the proceeds of the bonds would be used to repay Irving Trust for its loan to Begole. Although this argument may have merit logically, it is not consistent with the facts alleged by the petitioner himself. Immediately after Begole became the sole stockholder of Manhattan Casualty, he alone appointed all the members of the board of directors. (App., p. 128a) Manhattan's board was not an independent decision-making body as contemplated by standard corporate law and procedure; it was a rubber stamp for Begole and acted at his pleasure. Therefore, the deception, if any, perpetrated upon the board of directors had no practical effect.

It cannot be seriously argued that if Begole and Sweeny had simply stolen the bonds from Manhattan, sold them and kept the proceeds for themselves, there would be a federal claim under the Securities Acts. This in effect is what happened and the employment of the vote by an impotent board of directors does not change the reality. If Begole had informed the board that the proceeds of the bonds were to be used to purchase Manhattan and if one or more directors had objected, Begole could have easily and promptly removed the dissenters and replaced them with more agreeable persons. The board of directors of Manhattan Casualty was acting directly for and taking orders from Begole, who is the *only* person in this case covered by the provisions of the Securities Acts. Since defendant Begole cannot challenge the sale of the bonds, neither can petitioner who stands in his shoes.

The Commission attempts to overcome this deficiency in petitioner's claim by arguing that petitioner is prosecuting on behalf of Manhattan's creditors and policyholders. If there are such injured persons, they have more than adequate remedies in the New York State courts. It is doubtful, however, that there are such claims in existence, since it is public record that Manhattan's policyholders were fully reinsured shortly after it went into liquidation. Furthermore, the record herein does not reveal any claims or lawsuits by Manhattan's creditors. In any event, the inclusion of creditors and policyholders in the category of those persons permitted to sue under the Securities Acts is a matter for Con-

gressional action and not judicial interpretation. Policyholders and creditors as distinguished from investors are not persons covered by sections 17(a) or 10(b) as they are presently written.

Petitioner's complaint as amended by his briefs in the Courts below alleges a claim over which the federal courts should not have jurisdiction:

> An unrestricted application of rule 10b-5 is, however, also inconsistent with the purposes of the rule. The most liberal view, often expressed by the Commission, is that *anyone* who is damaged by a fraudulent transaction should be allowed to seek relief under 10b-5. This view would lead to almost unlimited liability. As an illustration, assume a defendant defrauds XYZ Corporation in a securities transaction, causing XYZ Corporation to go into bankruptcy. Following the SEC viewpoint, the stockholders of the corporation would be permitted to recover the loss in market value of their stock and, perhaps, even the creditors of the corporation would be permitted to recover their loan losses. Such broad coverage under section 10(b) was not the intent of Congress; the antifraud provisions were adopted to protect the trading process in the securities markets, not to provide a federal remedy for every injury that might in any way be connected with a securities fraud.*

*Boone and McGowan, *Standing to Sue Under SEC Rule 10b-5*, 49 Texas L. Rev. 617, 622 (1971)

CONCLUSION

The judgment of the Court of Appeals should be affirmed.

Respectfully submitted,

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August 31, 1971

No. 70-60

Supreme Court, U.S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1971

Superintendent of Insurance of the State of New York, as Liquidator of MANHATTAN CASUALTY COMPANY,

Petitioner,

v.

BANKERS LIFE AND CASUALTY COMPANY, ET AL.,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR RESPONDENT BANKERS LIFE AND CASUALTY COMPANY

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Petitioner mistakenly contends that this Court in this case should review the purchaser-seller requirement of *Birnbaum* v. *Newport Steel Corp.*; even if that requirement is reviewed, there would be no valid basis for altering the conclusion reached by the court below 17

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1971

No. 70-60

Superintendent of Insurance of the State of New York, as Liquidator of MANHATTAN CASUALTY COMPANY,
Petitioner,

v.

BANKERS LIFE AND CASUALTY COMPANY, ET AL.,
Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR RESPONDENT BANKERS LIFE AND CASUALTY COMPANY

Preliminary Statement

This brief is submitted on behalf of respondent Bankers Life and Casualty Company ("Bankers Life") in answer to the brief of petitioner, the Liquidator of Manhattan Casualty Company ("Manhattan"), and the brief for the Securities and Exchange Commission ("the SEC") as

amicus curiae.[1] As appears from their respective briefs, petitioner and the SEC differ with one another in substantial respects. While the SEC has limited itself to the question of the existence of federal jurisdiction in respect of the sale by Manhattan of certain government bonds, the proceeds of which were allegedly misappropriated, petitioner relies additionally upon (a) the purchase of Manhattan's stock by the defendant James F. Begole and (b) certain transactions involving certificates of deposit. As to Bankers Life, there is not to be found in the complaint or the comprehensive pre-trial discovery record a single factual allegation of wrongdoing in respect of any of the transactions relied upon by petitioner or the SEC. This brief, nevertheless, will demonstrate that petitioner has failed to state a claim maintainable under the federal securities laws and that the petitioner and the SEC have mistakenly challenged the decision below.

Questions Presented

1. May petitioner, as liquidator of Manhattan, maintain an action on Manhattan's behalf based upon alleged fraudulent transactions authorized and approved by Manhattan's sole stockholder?

2. Where the representative of a corporation purporting to sue for fraud under the federal securities laws fails to allege or show any manipulation of any securities market or other abuse of the trading process or any injury to any investor in, or shareholder of, the corporation, has a federal claim been stated?

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1. References to pages of petitioner's brief appear herein as "(pet. br.)" and to pages of the SEC's brief as "(SEC br.)."

3. Where in respect of one of multiple defendants, the record fails to disclose any basis for claiming any federal wrong and diversity of citizenship is absent, does federal jurisdiction exist in respect of such a defendant?

Counterstatement of the Case

Petitioner commenced this action in August 1963, more than one and one-half years after Bankers Life, in January 1962, had sold all the stock of Manhattan to defendant Begole (now deceased). Immediately after the commencement of the action, when the deposition upon oral examination of petitioner was taken, it became apparent that there was no factual basis upon which to have made Bankers Life a party to the action. Acknowledgment by petitioner of this unusual but significant circumstance was coupled with his claim that he required an opportunity to conduct discovery proceedings. (Tr. of petitioner's deposition, pp. 66-68, Oct. 8, 1963) Four and one-half years later, after approximately 40 witnesses had been examined and the discovery record consisted of some 12,000 pages of transcript with approximately 500 exhibits, it was clear, as it had been at the outset, that there was no proper basis upon which to retain Bankers Life as a party to the action.

The motion of Bankers Life to dismiss for lack of federal jurisdiction, granted by the United States District Court for the Southern District of New York, grew out of a prior motion by Bankers Life for summary judgment dismissing the complaint as to it on the ground (a) that there is no genuine issue as to any material fact and (b) that said defendant is entitled to judgment as a matter of law.

On June 19, 1968, the district court (Ryan, J.) entered an order denying the summary judgment motion "not

on the merits and without prejudice." (A 41a)[2] The court ruled that it was powerless to act upon the motion until petitioner's questionable claim of federal jurisdiction was determined.[3] (A 44a)

Accordingly, Bankers Life moved for an order granting judgment on the pleadings dismissing the complaint pursuant to Rules 12(c) and (h) of the Federal Rules of Civil Procedure. That motion was argued before the district court (Herlands, J.) on September 10, 1968, together with a similar motion made by respondents Belgian American Banking Corporation and Belgian American Bank & Trust Company. Corresponding motions made by respondents Irving Trust Company, Garvin, Bantel & Company and George K. Garvin were heard before Judge Ryan. At the court's discretion, the four motions were not consolidated.

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2. References to pages of the Appendix appear herein as "(A)".

3. When petitioner initiated this action in August 1963, he alleged in his complaint, as the sole jurisdictional basis for the action, "violations of Section 17A of the Securities Act of 1933 (U.S.C.A. § 77q(a))." (A 4a, ¶ 1) In a word, the sole claim of petitioner was that Manhattan was a defrauded purchaser of its own stock. Commencing with the respondents' answers to the complaint (A 14a-39a), and from time to time thereafter, petitioner was repeatedly put on notice of the lack of federal jurisdiction. Nevertheless, in August 1967, when petitioner represented he had completed all of his pre-trial discovery and declared his readiness for trial by filing the required Note of Issue, he again unqualifiedly stated therein that "a violation of Section 17(a) of the Securities Act of 1933" was the jurisdictional basis for the action.

Even after Judge Ryan in his June 19, 1968 order had specifically questioned the existence of federal jurisdiction, petitioner served a 59-page "Preliminary Pre-Trial Memorandum" and, in it, again expressly set forth petitioner's sole basis for federal jurisdiction as follows (pp. 1-2):

"A. JURISDICTION

This action is based on Section 17A of the Securities Act of 1933 (15 U.S.C.A. 77q(a)). The Court has jurisdiction under Section 22(a) of the same Act (15 U.S.C.A. 77(v))."

At no time since the action had been commenced in August 1963 had petitioner even remotely claimed any basis for federal jurisdiction other than Section 17(a) of the 1933 Act. Only when faced with the jurisdictional motions in the district court in 1968 did petitioner suddenly and for the first time contend that he was entitled to rely on some other federal statute – – and seized upon Section 10(b) of the Securities Exchange Act of 1934 (15 U. S. C. § 78j(b)) and Rule 10b-5 promulgated thereunder (17 C. F. R. 240.10b-5). In short, petitioner sought refuge in a new contention that if he could not sustain federal jurisdiction under Section 17(a) of the 1933 Act by claiming that Manhattan was a defrauded purchaser of its own stock, he might be able to do so under Section 10(b) of the 1934 Act by claiming that Manhattan, as a seller of government bonds, had been defrauded because defendant Begole and others had misappropriated the proceeds of the sale of those government bonds.

In opposing the motions to dismiss, the courts below permitted petitioner to draw upon the entire pre-trial discovery record and to present his case on the basis of both Section 17(a) of the 1933 Act and Section 10(b) of the 1934 Act. After full consideration of the issues raised in light of both sections, the courts below found that neither of them covered petitioner's claim. In a searching and exhaustive opinion dated June 3, 1969, Judge Herlands granted the two motions which were before him (A. 50a), and on June 9, 1969 Judge Ryan granted the two motions which were before him. (A 89a) Judgments were entered upon the decisions of Judges Herlands and Ryan, and upon petitioner's appeal from those judgments, the Court of Appeals for the Second Circuit affirmed. (A 97a) Petitioner's petition for rehearing and suggestion for rehearing *en banc* were denied on September 30, 1970. (A 112a, 113a)

The essence of petitioner's claim is corporate waste and mismanagement in that the defendant, the late James Begole, the purchaser of all of the stock of Manhattan on January 24, 1962, engaged in a scheme, with others, to deplete the assets of Manhattan and to conceal these facts from the Superintendent of Insurance of the State of New York by a complex series of transactions. Upon the basis of the entire record, Judge Herlands stated:

> "The complaint in this case presents no more than a complicated scheme of common law fraud." (A 88a)

Judge Herlands also stated:

> "Discovery herein has been extensive. The parties have not called to the Court's attention any facts which were not alleged in the complaint and which would, if leave to amend the complaint were granted, state a cause of action under the securities acts." (A 88a)

While petitioner, prior to the motions to dismiss for lack of federal jurisdiction, had numerous opportunities to seek amendment of his complaint, he did not do so. Instead, apparently aware of the futility of amendment and the inapplicability of the federal securities laws, petitioner, in 1965, commenced an action in the Supreme Court of the State of New York against the same defendants alleging the identical transactions and seeking the identical relief sought here.[4] (A 124a) The state court action is still pending.

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4. New York Civil Practice Law and Rules, Rule 3117(c), provides in part: "When an action has been brought in any court of any state or of the United States and another action involving the same subject matter is afterward brought between the same parties or their representatives or successors in interest all depositions taken in the former action may be used in the latter as if taken therein."

Judge Ryan, in granting the motions before him, stated that dismissal of the complaint was "without prejudice to prosecution of the action plaintiff filed and is pending in the Supreme Court, County of New York." (A 90a) He expressed full agreement with the opinion of Judge Herlands and also found that the "fraud alleged was not in the purchase or sale of securities, but was waste of Manhattan's assets by diversion and misappropriation of its securities." (A 89a) He further agreed "with Judge Herlands that 'the complaint in this case presents no more than a complicated scheme of common law fraud' over which there is no independent federal jurisdiction." (A 89a)

In affirming the decisions of the district court, the court of appeals found that there had not been any manipulation of any securities market or other abuse of the trading process; that no investor in, or shareholder of, Manhattan had suffered injury; and therefore, that a federal claim had not been stated. (A 107a) As will hereinafter appear, there was no occasion to consider, and, as the court of appeals stated, it did not decide that creditors of Manhattan "do not have any remedy under general state tort law for the fraud practiced on their debtor, but only that the federal Securities Acts have not provided a federal forum for its enforcement." (A 107a)

Argument

Point I

Petitioner has failed to allege, or show any facts in support of, any claim against Bankers Life; federal jurisdiction does not exist as to it.

Petitioner's statement of "The Facts" is virtually devoid of any references to the allegations of the complaint or any portion of the pre-trial discovery record. (pet. br.

6-12) Petitioner presents questions for review based, in large part, upon imagined circumstances and speculative conclusions which have not been pleaded and cannot be supported by the discovery record. The haphazard character of petitioner's "Facts" is exemplified by the reckless use of inflammatory references to "perpetrators" and "schemers", though the discovery record shows that Bankers Life perpetrated nothing and had no connection whatsoever with any scheme.[5]

The complaint (A 4a) consists of 40 paragraphs, most of which have nothing whatsoever to do with Bankers Life. As to Bankers Life, the complaint alleges no more than that it is an Illinois corporation (¶ 3); that it owned all of the capital stock of Manhattan prior to January 24, 1962 (¶ 17); that negotiations for the sale of said stock had been carried on for a period of approximately three months, between November 1961 and January 19, 1962 (¶ 19); that on January 19, 1962, a contract for the sale of said stock was entered into between Bankers Life, as seller, and defendant James Begole, as purchaser (¶ 20); that said contract provided for a price to be paid Bankers Life of $5,000,000 by bank or certified check which was to be delivered at the closing on January 24, 1962 (¶ 20); that on

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5. Petitioner's inaccurate statement of "The Facts" apparently has led the SEC astray. Thus, for example, the SEC, apparently unfamiliar with the factual distinctions of record between Bankers Life and other defendants, erroneously lumps defendants together in instances such as the following: (a) "with the aid of *the other named defendants,* they [the purchasers of the Manhattan stock] embarked upon a scheme to use Manhattan's own assets to pay for the purchase of its stock." (SEC br. 5) (emphasis added); (b) "fraudulent conduct for which *any or all of the respondents* can be held responsible" (SEC br. 12) (emphasis added); and (c) "failure of *the defendants* to disclose their intention to misappropriate the proceeds". (SEC br. 21) (emphasis added)

The cavalier technique thus employed in bandying about generalized references to "defendants" and "respondents" is incompatible with the fully developed discovery record.

the morning of January 24, 1962, at the closing, there was delivered to Bankers Life a check of Irving Trust Company in the amount of $5,000,000 (¶ 26).

The complaint then refers to events which allegedly occurred later in the day of January 24, 1962 (¶¶ 27-30) and thereafter (¶¶ 31-39), but none of those allegations make any reference to Bankers Life. Thus, each of the alleged frauds, namely the alleged frauds involving (a) the purchase by defendant Begole of all of the Manhattan stock, (b) the subsequent sale of Manhattan's government bonds, and (c) the purchase of certificates of deposit, concern defendants other than Bankers Life.

The absence of any connection of Bankers Life to the alleged frauds was confirmed by petitioner's attorney, who, in describing the complaint in open court, stated:

> "Thereafter, the complaint alleges that defendants, other than Mr. Parker's client [Bankers Life] entered into a scheme to cover up this depletion of the corporate assets which was successful for about a year and a half." (Tr. of petitioner's deposition, p. 196, Nov. 6, 1963)

The complaint did not allege, and discovery failed to disclose, any connection between Bankers Life and the frauds alleged.

In June 1968, after petitioner had concluded all pretrial discovery and represented to the district court that he was prepared to proceed to trial, Judge Ryan entered his order with respect to the summary judgment motion of Bankers Life in which he stated:

> "Nowhere is it charged that the negotiations for the raising of the purchase price were participated in by BANKERS LIFE or even that it had any knowledge of them." (A 42a)

In connection with the subsequent motions to dismiss for lack of federal jurisdiction, Judge Herlands, upon the basis of the complaint and the entire pre-trial discovery record, also found that there was no charge in any respect that any information was either improperly disclosed or withheld in respect of the contract for the purchase and sale of Manhattan's stock. Thus, as Judge Herlands wrote:

> "The complaint does not charge that any misrepresentations, deceit or non-disclosures had been made or practiced upon any party in connection with this contract of purchase and sale." (A 52a)

As so clearly appears from the briefs of the petitioner and the SEC, they are principally concerned with the sale of Manhattan's government bonds with which Bankers Life had no connection whatsoever. Thus, the transactions complained of as the basis of the alleged fraud relate to defendants other than Bankers Life. As the court of appeals correctly observed:

> "In this lawsuit our attention has been shifted away from that conventional purchase and sale of the Manhattan stock to the legerdemain employed by the buyer to obtain the $5,000,000 with which to pay for the stock." (A 98a-99a)

Confirming the total absence of any connection between Bankers Life and the buyer's activities in raising the funds to pay for Manhattan's stock by misappropriating Manhattan's assets, petitioner argues (br. 16 *et. seq.*) that it was the buyer's board of directors which was misled in connection with the sale of Manhattan's government bonds after Manhattan's sole stockholder-purchaser had acquired control of Manhattan.[6]

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6. The following appears in petitioner's brief:
"A. § 10(b) and Rule 10b-5 are Violated When a Board of Directors is Fraudulently Induced to Author-

Since no claim has been — — nor, on the basis of the discovery record, can be — — alleged against Bankers Life, it is clear that no federal jurisdiction exists as to it. And this fact certainly cannot be altered by any interpretation of the legislation which this Court is called upon to review. Bankers Life is simply not involved in the argument of petitioner and the SEC whether there were schemes or devices employed by others in connection with the sale of Manhattan's government bonds or the transactions relating to the various certificates of deposit. Accordingly, in no respect can Section 17(a) of the 1933 Act or Section 10(b) of the 1934 Act serve as the basis of any claim against Bankers Life; dismissal of the complaint was unquestionably correct as to Bankers Life.

Point II

Petitioner, as liquidator of Manhattan, cannot maintain an action on behalf of Manhattan based upon the alleged fraud of Manhattan's sole stockholder; moreover, there is no allegation or showing of any injury to any party entitled to protection of the federal securities laws and, accordingly, federal jurisdiction does not exist over the subject matter of this action.

The complaint, fully supplemented by the comprehensive discovery record, does not state a claim cognizable under the federal securities laws.

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ize the Sale of Securities of a Corporation." (pet. br. 17)

"B. § 10(b) and Rule 10b-5 are Violated When the Proceeds From a Sale of Securities are Misappropriated." (pet. br. 24)

Similarly, the SEC states:

"[I]f petitioner cannot prove fraud with respect to the sale of those bonds, he also could not recover under his two other theories." (SEC br. 7n.6)

A. Petitioner, as liquidator of Manhattan, cannot maintain an action on behalf of Manhattan based upon the alleged fraud of Manhattan's sole stockholder.

Petitioner contends that the alleged fraud of the sole stockholder of Manhattan in misappropriating its assets is actionable and that petitioner is entitled to maintain an action by reason thereof. The contention thus made is erroneous for the following reasons:

1. The corporation has no right to maintain an action based upon the alleged fraud of its sole stockholder who authorized and approved all of the transactions relating to the alleged fraud. See *Field* v. *Lew,* 184 F.Supp. 23, 27 (E.D.N.Y. 1960), *aff'd,* 296 F.2d 109 (2d Cir. 1961), *cert. denied,* 369 U.S. 859 (1962); *General Hatters Supply Co.* v. *Hartman,* 148 N.Y.S.2d 90 (Sup. Ct. N.Y. Co. 1955).

2. Since the corporation may not maintain an action based upon the alleged fraud of its sole stockholder, petitioner, who is the corporation's representative, cannot maintain such an action on its behalf. See *Field* v. *Lew, supra.*

3. Since the corporation has no right of action, the fact that the alleged fraud involved the purchase or sale of securities is of no consequence. Hence, Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder have no application in the circumstances here.

While creditors, if any, of Manhattan may have suffered injury as a result of the alleged fraud committed by its sole stockholder and by reason thereof may maintain an

action in the state courts, they may not assert any rights under the federal securities laws. Even if it be assumed, contrary to the record in this case, that any injured creditors exist, they are neither purchasers nor sellers of securities and, therefore, are not entitled to protection under the federal securities laws. (pp. 17-20, *infra*) It is interesting to observe that petitioner who, before the district court, vigorously argued that Manhattan's creditors had been defrauded (petitioner's memorandum served September 3, 1968, pp. 35, 42), abandoned his argument as to a fraud on creditors before the court of appeals and stands mute in this regard here.[7]

Nevertheless, even if it were assumed *arguendo* that, as the SEC contends (SEC br. 28), the federal securities laws should be expanded to include protection of creditors, this is certainly not a case in which those laws should be so judicially enlarged. A more inappropriate case for the interpretation sought by the SEC can hardly be imagined. Upon the record here, the SEC has no basis to argue hypothetically as if there were creditors who were injured or to seek, in this case, expansion of the federal securities laws to cover such hypothetical creditors. The comprehensive discovery record before this Court is devoid of any facts showing any injury to any creditor, or even the existence of any creditor of Manhattan.[8]

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7. Significantly, in the course of pre-trial discovery, petitioner had flatly asserted that any inquiry as to who might have suffered damages and the amount thereof, if any, was totally irrelevant to the issues in this action. (affid. of M. P. Unger, October 11, 1967, p. 7)

8. For the same reason, *Bailes* v. *Colonial Press, Inc.*, No. 29048 (5th Cir. June 15, 1971), which was decided after the briefs of petitioner and the SEC were served, is inapposite in spite of its apparent unique extension of Rule 10b-5 for the benefit of a corporation's creditors. (p. 16, *infra*)

B. Petitioner and the SEC have misconstrued the reasoning of the court of appeals and overlooked the fact that in reaching its decision the court below correctly interpreted and applied the legislative purposes of the federal securities laws; furthermore, there is no allegation or showing of any injury to any person entitled to protection of the federal securities laws.

Both petitioner and the SEC not only have failed to recognize that petitioner, as the representative of Manhattan, has no federal right of action, but their principal arguments presented in criticism of the decisions below do not fairly reflect the careful attention which those courts gave to the purposes of the federal securities laws.

Thus, the SEC, on the one hand (br. 22), makes the irrelevant charge that the court of appeals in reaching its decision attempted to "fragment the transaction by which Manhattan's securities were sold into several parts", and the petitioner, on the other hand (br. 20), erroneously asserts that the court below arrived at its decision by application of a so-called "terms of the sale test" in respect of the sale of Manhattan's government bonds. To the contrary, the court below reached decision by an analysis of the Congressional purposes, and the language, of the very provisions of the securities laws relied upon by petitioner and the SEC. The court of appeals addressed itself to the question whether the fraud alleged, in the language of Rule 10b-5, was "in connection with" (A 106a) the purchase or sale of any security.[9]

9. Similarly, Judge Herlands had shown his full awareness of the need to determine whether a fraud had been committed "in connection with" the purchase or sale of securities within the meaning of Rule 10b-5. As Judge Herlands wrote:

> ". . . the sale of Manhattan's portfolio and the purchase of the Manhattan shares were necessary steps toward the ultimate looting of Manhattan's assets. *But Rule 10b-5 requires the employment of fraud in connection with a security transaction, which is essentially different from the effectuation of a security transaction in connection with a fraudulent activity.*" (A 83a-84a) (emphasis added)

In answering that question, the court of appeals expressly recognized that the "scope of the rule must be assessed in light of the purposes of the legislation from which it derives, which we recently found to be 'to promote free and open public securities markets and to protect the investing public from suffering inequities in trading.'" (A. 106a) Though Congress undoubtedly could have expanded the securities laws to afford protection to creditors, in addition to the investing public, it did not choose to do so. As the court of appeals stated:

> "The civil liabilities provisions of the federal Securities Acts, beginning at 15 U. S. C. § 77(1) were 'part of a broad integrated program designed to obtain honest dealings in securities,' *Wilko* v. *Swan*, 127 F. Supp. 55, 58 (S. D. N. Y. 1955), not one to create an unlimited federal right of action for damages for all who have been defrauded in any area of economic activity." (A 107a)

While fiduciary obligations of controlling shareholders, upon which the SEC relies (SEC br. 28), may be enforceable by injured creditors under state law, the absence of any injury to any investor or shareholder of Manhattan renders the federal securities laws inapplicable. It is true that the allegedly misappropriated assets of Manhattan consisted of the proceeds of the sale of certain securities, but such an act of mismanagement or breach of fiduciary duty does not give rise to a right of action under the federal securities laws simply because securities are involved. *Drachman* v. *Harvey*, No. 35077 (2d Cir. July 21, 1971); *Herpich* v. *Wallace*, 430 F. 2d 792 (5th Cir. 1970); *O'Neill* v. *Maytag*, 339 F. 2d 764 (2d Cir. 1964); *Birnbaum* v. *Newport Steel Corp.*, 193 F. 2d 461 (2d Cir.), *cert. denied*, 343 U. S. 956 (1952); *Cohen* v. *Colvin*, 266 F. Supp. 677 (S.D.N.Y.

1967); *Hoover* v. *Allen,* 241 F. Supp. 213 (S. D. N. Y. 1965); *Barnett* v. *Anaconda Co.,* 238 F. Supp. 766 (S. D. N. Y. 1965); *Pettit* v. *American Stock Exchange,* 217 F. Supp. 21 (S. D. N. Y. 1963).

As was observed in *Pettit:*

> "[C]ourts have been disinclined to allow 'innumerable facets of internal corporate affairs' to be included within federal question jurisdiction on the basis of a purchase or sale of securities that is only incidental to a major mismanagement issue." 217 F. Supp. at 25.

Nevertheless, both petitioner and the SEC mistakenly argue that *any* act of corporate mismanagement or breach of a fiduciary duty having an incidental security transaction gives rise to a right of action under the securities laws even though unaccompanied by manipulation or other market or trading abuse or injury to stockholders or investors. Recently decided *Bailes* v. *Colonial Press, Inc., supra,* obviously was also ill-considered to the extent that the Fifth Circuit upheld the sufficiency of a claim under Section 10(b) and Rule 10b-5 because it alleged that those who became creditors after the alleged fraud may have been damaged as a result thereof.

The infirmity of such a position was recently commented upon in a penetrating article as follows:

> "An unrestricted application of rule 10b-5 is, however, also inconsistent with the purposes of the rule. The most liberal view, often expressed by the Commission, is that *anyone* who is damaged by a fraudulent transaction should be allowed to seek relief under 10b-5. This view would lead to almost unlimited liability. As an illustration, assume a de-

> fendant defrauds XYZ Corporation in a securities transaction, causing XYZ Corporation to go into bankruptcy. Following the SEC viewpoint, the stockholders of the corporation would be permitted to recover the loss in market value of their stock and, perhaps, even the creditors of the corporation would be permitted to recover their loan losses. Such broad coverage under section 10(b) was not the intent of Congress; the antifraud provisions were adopted to protect the trading process in the securities markets, not to provide a federal remedy for every injury that might in any way be connected with a securities fraud." Boone and McGowan, *Standing To Sue Under SEC Rule 10b-5,* 49 Texas L. Rev. 617, 622 (1971) (footnotes omitted)

In any event, apart from any interpretation of legislative intent in respect of Section 10(b) of the 1934 Act, since upon the record here no injury to any shareholder, investor or even creditor appears, it follows that the SEC has mistakenly selected this case for the purpose of seeking judicial expansion of the legislation relied upon by petitioner.

Point III

Petitioner mistakenly contends that this Court in this case should review the purchaser-seller requirement of *Birnbaum* v. *Newport Steel Corp.*; even if that requirement is reviewed, there would be no valid basis for altering the conclusion reached by the court below.

Petitioner's argument (br. 32-35) that the purchaser-seller requirement first enunciated in *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied,* 343 U.S. 956 (1952) should be abolished need not be considered by

this Court in this case. That requirement of *Birnbaum* merely goes to the question of a party's standing to sue under the federal securities laws — a requirement which is met where the party suing is held to be a purchaser or seller of securities. Since it was held below that petitioner did have standing to sue in respect of the sale of Manhattan's government bonds (A 80a), it is an unnecessary and futile exercise for petitioner to contend also that he has standing to sue in respect of the purchase of the Manhattan stock and the later transactions relating to certificates of deposit. The court below dismissed the complaint, not because petitioner has no standing to sue, but because petitioner had failed to assert a federal claim. Even the SEC has expressly acknowledged that there is no need for this Court to concern itself in this case with the question of the abolition of *Birnbaum's* purchaser-seller requirement. (SEC br. 7n.6)

At the same time, the SEC appears to indulge in a strange dichotomy. While, on the one hand, the SEC suggests that this Court may leave undisturbed the *Birnbaum* purchaser-seller requirement (SEC br. 7n. 6), it argues, on the other hand, for expansion of Rule 10b-5 to include protection to creditors of a corporation who are neither purchasers nor sellers of its securities. (SEC br. 28). Not only is the contention of the SEC based upon an unsupported assumption that in this case creditors exist, but the contention that, in private civil suits for damages, Rule 10b-5 was intended to cover creditors of a corporation is against the overwhelming weight of authority.

With the sole possible exception of *Bailes* v. *Colonial Press, Inc., supra,* in every known case where the *Birnbaum* purchaser-seller requirement has been considered, the courts have uniformly applied that requirement in order to sustain or reject a party's standing to sue. *E.g., Iroquois Industries, Inc.* v. *Syracuse China Corp.,* 417 F.2d 963 (2d Cir.

1969), *cert. denied,* 399 U.S. 909 (1970); *Herpich* v. *Wallace, supra; Mader* v. *Armel,* 402 F.2d 158 (6th Cir. 1968), *cert. denied sub nom. Young* v. *Mader,* 394 U.S. 930 (1969); *Dasho* v. *Susquehanna Corp.,* 380 F.2d 262 (7th Cir.), *cert. denied sub nom. Bard* v. *Dasho,* 389 U.S. 977 (1967); *Erling* v. *Powell,* 429 F.2d 795 (8th Cir. 1970); *The Greater Iowa Corp.* v. *McLendon,* 378 F.2d 783 (8th Cir. 1967).

The *Birnbaum* purchaser-seller requirement has been honored by the courts for almost two decades in numerous cases presenting highly diversified fact situations. While it has been flexibly applied, it is not difficult to foresee the unnecessary flood of potential litigation in the federal courts which could follow elimination of the *Birnbaum* requirement and the SEC's proposed judicial enlargement of Rule 10b-5 by giving creditors standing to sue thereunder.

Adhering to the teaching of this Court, the court below in *Iroquois Industries, Inc.* v. *Syracuse China Corp., supra,* has warned against the judicial extension of Rule 10b-5 reflected in *Bailes, supra.* In *Iroquois,* the court wrote:

> "The *Birnbaum* rule recognizes the policy of Congress in enacting Section 10(b) and of the Commission in adopting Rule 10b-5, namely, *the protection of defrauded purchasers and sellers.* It is not the province of the courts to extend Section 10(b) to apply to transactions not intended to be covered by Congress. We do well to heed the words of Mr. Justice Black, writing for the Court in a case about another section of the 1934 Act, *Blau* v. *Lehman,* 368 U. S. 403, 413, 82 S. Ct. 451, 457, 7 L. Ed. 2d 403 (1962):
>
> > 'Congress can and might amend [the Act] if the Commission would present to it the policy arguments it has presented to us, but we think that Con-

gress is the proper agency to change an interpretation of the Act unbroken since its passage, if the change is to be made.' " 417 F. 2d at 969 (emphasis added)

While the SEC contends that the decision below will tend to impede its enforcement capabilities and raises the spectre of diminished efficacy of the anti-fraud provisions (SEC br. 9-10), there is far greater likelihood that acceptance of the position of the SEC taken here will needlessly wrest from the state courts claims which properly lie within their jurisdiction rather than the jurisdiction of the federal courts.

Point IV

The writ of certiorari should be dismissed.

It is respectfully submitted that the writ of certiorari was improvidently granted and therefore should be dismissed. Briefly stated, the reasons are these:

1. The argument of petitioner and the SEC that Manhattan was defrauded is based upon a factitious separation of the corporate legal entity from its sole beneficial owner in order to invent a mythical victim of the sole shareholder's fraud. Additionally, the SEC, but not the petitioner, makes the further untenable argument that such a claim should be maintainable for the benefit of creditors in spite of the fact that neither the complaint nor the record can support the existence of any injured creditor or the existence of any creditor at all.

2. The allegations of the complaint, together with petitioner's unsupported statement of the purported facts of this case, amount to no more than a claim of

corporate waste and mismanagement in respect of which incidental securities transactions took place. There is not even a faint implication of any manipulation or other abuse of any securities market or the trading process. There is certainly no claim—nor could there be—that any investors or shareholders have been damaged or defrauded. In fact, having failed to claim or show that any creditors have been injured by the transactions complained of, petitioner has not even alleged a fraud for which relief can be granted.

3. The *Birnbaum* purchaser-seller requirement is not properly before this Court for review. The district court expressly held, and the court of appeals assumed, that petitioner had the requisite standing to sue with respect to the sale of Manhattan's government bonds. Thus, the presentation by petitioner of the question of the abolition of the rule is a futile exercise in which the SEC has refused to join. Moreover, for almost two decades, the requirement has withstood challenge in the innumerable cases which have established its validity as a rule of law.

4. The unrestricted interpretation of the words "in connection with the purchase or sale of any security" sought by petitioner and the SEC, not only would eradicate all limits on private civil actions for damages under Section 10(b) of the 1934 Act and Rule 10b-5, but it would go far beyond the intent of Congress "to promote free and open public securities markets and to protect the investing public from suffering inequities in trading." *SEC* v. *Texas Gulf Sulphur Co.*, 401 F. 2d 833 (2d Cir. 1968) (*en banc*), *cert. denied sub nom. Coates* v. *SEC*, 394 U. S. 976 (1969). Not only do the highly individualized facts of this case render it totally in-

appropriate as a vehicle for such action, but if the unlimited interpretation of the statutory language, for which petitioner and the SEC contend, is to be adopted, it is respectfully submitted that the proper body to make such determination is Congress rather than this Court. See *Blau* v. *Lehman*, 368 U. S. 403, 413 (1962).

Conclusion

For all of the foregoing reasons, it is respectfully submitted that the question of federal jurisdiction was correctly decided by the court below; that a federal claim has not been stated; that federal jurisdiction does not exist; and that the judgment below should be affirmed or the writ of certiorari should be dismissed.

It is respectfully submitted further that, at the very least, no claim has been asserted against Bankers Life; that federal jurisdiction does not exist as to Bankers Life; and that the judgment below should be affirmed as to it.

Respectfully submitted,

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August 31, 1971.

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Supreme Court, U.S.
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No. 70-60

IN THE

Supreme Court of the United States

OCTOBER TERM, 1971

SUPERINTENDENT OF INSURANCE OF THE STATE OF NEW YORK, as Liquidator of MANHATTAN CASUALTY COMPANY,
Petitioner,

against

BANKERS LIFE AND CASUALTY COMPANY, IRVING TRUST COMPANY, BELGIAN AMERICAN BANKING CORPORATION, BELGIAN AMERICAN BANK & TRUST COMPANY, GARVIN, BANTEL & COMPANY, GEORGE K. GARVIN,
Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR RESPONDENT IRVING TRUST COMPANY

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1971

No. 70-60

SUPERINTENDENT OF INSURANCE OF THE STATE OF NEW YORK, as Liquidator of MANHATTAN CASUALTY COMPANY,
Petitioner,

against

BANKERS LIFE AND CASUALTY COMPANY, IRVING TRUST COMPANY, BELGIAN AMERICAN BANKING CORPORATION, BELGIAN AMERICAN BANK & TRUST COMPANY, GARVIN, BANTEL & COMPANY, GEORGE K. GARVIN,
Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR RESPONDENT IRVING TRUST COMPANY

Preliminary Statement

In the complaint Petitioner, the Liquidator of Manhattan Casualty Company ("Manhattan"), seeks judgment for $5,500,000 and alleges that the Respondents and others defrauded Manhattan in connection with the sale of all the outstanding shares of Manhattan by defendant Bankers Life and Casualty Company ("Bankers Life") to defendant James F. Begole ("Begole") in violation of Section 17(a)

of the Securities Act of 1933 (15 U.S.C. § 77q(a)). Named as defendants, in addition to the Respondents, were Begole, New England Note Corporation ("New England"),[1] John F. Sweeny ("Sweeny") and Standish T. Bourne ("Bourne"). As a result of the alleged fraud defendant Begole became the sole shareholder of Manhattan.

In 1965, in the midst of extensive pretrial discovery and in apparent recognition of the absence of federal jurisdiction, Petitioner commenced an action—still pending—in the Supreme Court of the State of New York against the same defendants, alleging virtually the same facts and seeking relief under state law identical to the relief sought in this action. (The complaint in the New York State action appears in the Appendix at pages 124a-141a.)

In an Order dated June 19, 1968, the District Court (Hon. Sylvester J. Ryan) questioned its jurisdiction over the subject matter of this action and indicated the need for resolution of that issue. (App., p. 40a) Respondents Bankers Life, Belgian American Banking Corporation ("Belgian Banking") and Belgian American Bank & Trust Company ("Belgian Trust") thereupon moved before Hon. William B. Herlands to dismiss the complaint under Rules 12(c) and 12(h) of the Federal Rules of Civil Procedure on the grounds that the District Court lacked subject matter jurisdiction and the complaint failed to state a claim under federal law. Respondents Irving Trust Company ("Irving"), Garvin, Bantel & Company ("Garvin, Bantel") and George K. Garvin ("Garvin") thereafter moved before Hon. Sylvester J. Ryan for the same relief.

On June 3, 1969, Judge Herlands filed his opinion granting the motions of Respondents Bankers Life, Belgian Banking and Belgian Trust. (App., p. 50a) On June 9,

1. New England Note Corporation was formerly named New England Acceptance Co., Inc. This corporation is hereinafter referred to as "New England".

1969, Judge Ryan filed his opinion granting the motions of Respondents Irving, Garvin, Bantel and Garvin. (App., p. 91a)

On July 22, 1970, the Court of Appeals for the Second Circuit affirmed the judgments of Judge Herlands and Judge Ryan dismissing the complaint. (App., p. 97a) Petitioner's petition for rehearing and suggestion for rehearing *en banc* were denied on September 30, 1970. (App., pp. 112a, 113a)

In opposing Respondents' jurisdictional motions and in connection with his application for leave to amend the complaint, Petitioner resorted to use of the entire record accumulated during the more than four years of pretrial discovery. Judge Herlands considered the motions to dismiss on the basis of the allegations of the complaint, the additional facts presented in Petitioner's brief and Petitioner's "amendatory allegations presented in open court." (App., p. 76a; see also App. pp. 52a and 66a) After a comprehensive analysis of all the facts presented by Petitioner, Judge Herlands concluded that the "complaint in this case presents no more than a complicated scheme of common law fraud" and held that there was no federal jurisdiction under either Section 17(a) of the Securities Act of 1933 or Section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. § 78j(b)). (App., p. 88a)

Judge Ryan, in granting the motions before him, expressed full agreement with the opinion of Judge Herlands and also found that the "fraud alleged was not in the purchase or sale of securities, but was waste of Manhattan's assets by diversion and misappropriation of its securities." He further agreed "with Judge Herlands that 'the complaint in this case presents no more than a complicated scheme of common law fraud' over which there is no independent federal jurisdiction." (App., p. 89a) Judge Ryan expressly stated that the dismissal of the complaint was

without prejudice to the prosecution by Petitioner of his pending New York Supreme Court action. (App., p. 90a)

Similarly, the Court of Appeals in affirming the judgments of the District Court stated that it did "not decide that the creditors of Manhattan do not have any remedy under general state tort law for the fraud practiced on their debtor, but only that the federal Securities Acts have not provided a federal forum for its enforcement." (App., p. 107a)

Questions Presented

1. Does a misappropriation of corporate funds which may be traced in part to the proceeds from the sale of corporate securities constitute a fraud in connection with the sale of those securities in violation of the federal securities laws?

2. Can a corporate seller of securities recover under the federal securities laws when its sole stockholder authorizes and approves the allegedly fraudulent sale of its securities?

3. Do creditors of a corporation have standing under the federal securities laws to obtain judicial review of securities transactions of that corporation and decisions of the corporation's management with respect thereto?

Summary Statement of the Case

This summary statement of the case contains the most significant events claimed by Petitioner to describe a violation of the federal securities laws. In the Complaint herein, in his complaint in the New York State action, in his answers to interrogatories and in the many briefs he has filed in this action, Petitioner has depicted

numerous—and occasionally inconsistent—incidents which allegedly caused $5,500,000 damage to Manhattan. This summary statement does not attempt to include all such details, but merely outlines those alleged facts which Petitioner claims support the legal theories on which he now relies. A more complete statement of the facts with citations is set forth as Attachment A to this brief.

The events leading to this action commenced in late 1961 when Begole negotiated with Bankers Life for the acquisition of its wholly-owned subsidiary, Manhattan. Begole contracted to purchase Manhattan on January 24, 1962 for $5,000,000. Financing for Begole's purchase was arranged by Bourne, who enlisted the assistance of Garvin, a partner in Garvin, Bantel.

On January 24, 1962, at the request of Garvin, C. Joseph Gunter ("Gunter"), an Assistant Secretary of Irving, drew a $5,000,000 Irving check payable to Bankers Life. At the closing of the sale of Manhattan, the check was delivered to Bankers Life in payment for Begole's purchase of all of the Manhattan capital stock.

Immediately after acquiring Manhattan, Begole installed a new Board of Directors, including himself as Chairman. The new Board then elected Begole's nominees as officers—including Sweeny as President—and authorized the sale of Manhattan's Treasury bonds and the purchase of a $5,000,000 certificate of deposit from Belgian Trust.

Later on January 24, 1962, Gunter received the Manhattan Treasury bonds which were sold through Garvin, Bantel and delivered to the purchaser, Second District Securities Co., Inc. Fair value in the amount of $4,854,552.67 was paid by the purchaser for the bonds. Gunter credited the $4,854,552.67 to an account of Manhattan at Irving and also credited to that account $150,000 received by check from Manhattan.

Also on January 24, 1962, Gunter, pursuant to instructions from Garvin, drew a $5,000,000 Irving check payable to Belgian Trust and delivered it to Sweeny at the Belgian American Banks. Sweeny deposited the check with Belgian Trust which issued a six month $5,000,000 certificate of deposit to Manhattan. Both Sweeny, as President of Manhattan, and Manhattan's Assistant Treasurer endorsed the certificate of deposit to New England. Sweeny gave the CD to Bourne, President of New England, who in turn endorsed it to Belgian Banking. Thereupon Belgian Banking loaned $5,000,000 to New England and for collateral took possession of the Belgian Trust CD which had been endorsed by Sweeny and Bourne. The proceeds of this loan were paid in the form of a $5,000,000 Belgian Banking check payable to Irving for the account of New England which was delivered to Gunter. At the same time Belgian Banking made another loan to New England of $250,000 which was secured by the outstanding shares of Manhattan which had been assigned by Begole to New England.

On July 24, 1962, Belgian Trust's six month certificate of deposit payable to Manhattan matured and the loans by Belgian Banking to New England became due. At that time certain new arrangements were effectuated. Belgian Trust credited Manhattan's account with $74,383.56 interest on the Manhattan CD, and the principal amount of the CD which had been endorsed on behalf of Manhattan by Sweeny was used to purchase a new six-month $5,000,000 Belgian Trust CD for Manhattan. This new CD was delivered to Sweeny, as President of Manhattan, and kept by him in his possession. Belgian Banking's loans to New England were extended to January 24, 1963.

In August, 1962, Sweeny returned the certificate of deposit he had been holding to Belgian Trust, and Manhattan was issued a negotiable six month $5,000,000 CD, also dated July 24, 1962. Sweeny endorsed this new CD on behalf of

Manhattan and delivered it to Belgian Trust together with instructions to deposit its proceeds upon maturity in Manhattan's account at Belgian Trust. In addition, he delivered a $500,000 CD of the First National Bank of Boston, which was also owned by Manhattan, to Belgian Trust. Both CDs were delivered on the assurance of a letter from Belgian Trust stating that they would be held in trust for Manhattan.

On January 25, 1963, additional transactions occurred which Petitioner claims were part of the conspiracy to defraud Manhattan. Belgian Trust credited Manhattan's account with $5,590,977.62. $5,000,000 of this sum represented principal of the Belgian Trust CD issued to Manhattan in August of 1962; $75,616.44 represented interest on that CD; $500,000 represented principal of the First National Bank of Boston CD which had been delivered to Belgian Trust; and $15,361.18 represented interest on the First National Bank of Boston CD.

Also on January 25, 1963, Belgian Trust issued a $5,500,000 check payable to Irving and charged it against the Manhattan account which had theretofore been credited with $5,590,977.62. Irving, pursuant to instructions from Garvin, issued a $5,250,000 check payable to Belgian Banking. The Belgian Trust check to Irving and Irving's check to Belgian Banking were exchanged on January 25, 1963 at the Belgian American Banks. The Irving check was used by Belgian Banking to repay its $5,250,000 loans to New England. Pursuant to instructions from Garvin, the $5,500,000 Belgian Trust check payable to Irving was credited to the Garvin, Bantel account at Irving and the $5,250,000 Irving check payable to Belgian Banking was debited to the Garvin, Bantel account. The net effect of these alleged transactions was to apply funds in the Manhattan account at Belgian Trust to the repayment of the Belgian Banking loans to New England.

As a consequence of the foregoing transactions, Petitioner suing in Manhattan's behalf alleges that Manhattan was defrauded of $5,500,000 in violation of the federal securities laws. Petitioner has suggested two alternative times at which Manhattan funds may have been misappropriated. Under Petitioner's first theory, Manhattan was injured on January 24, 1962, when $5,000,000 of $5,004,552.67 (consisting of $4,854,552.67 deposit of proceeds of securities plus $150,000 cash deposit) in the Manhattan account at Irving were diverted by Begole to pay for the check to Bankers Life used for the purchase of the Manhattan stock. Under Petitioner's second theory, Manhattan was injured on January 25, 1963, when $5,500,000 of funds in its account at Belgian Trust were misappropriated; $5,250,000 of which was used to repay the Belgian Banking loans to New England and $250,000 of which was diverted by Begole and Sweeny. Under the second theory, the $5,000,000 Irving check to Bankers Life was paid for by the $5,000,000 Belgian Banking check payable to Irving for the account of New England which represented the proceeds of one of the Belgian Banking loans to New England.

ARGUMENT

I.

MISAPPROPRIATION OF CORPORATE FUNDS WHICH MAY BE TRACEABLE IN PART TO THE PROCEEDS FROM A SALE OF CORPORATE SECURITIES DOES NOT CONSTITUTE A FRAUD IN CONNECTION WITH THAT SALE IN VIOLATION OF THE FEDERAL SECURITIES LAWS.

Petitioner claims that Manhattan was defrauded of $5,500,000 as a result of an alleged fraud in connection with the sale of securities in violation of Section 10(b) of the 1934 Act. The alleged fraud consists of a misappropriation of corporate funds which may be traceable in part to a

corporate securities transaction. Upon analysis, however, such a misappropriaion does not constitute a fraud in connection with a securities transaction and was not intended by Congress to constitute such a fraud. To hold otherwise would result in federal preemption of a major part of state corporate law.

A. There is a distinction between a fraud in connection with a security transaction and the effectuation of a security transaction as an incident to the perpetration of a fraud.

This case involves the proper interpretation of the statutory phrase "in connection with the purchase or sale of any security". The Second Circuit recently reaffirmed its interpretation given to that phrase herein by stating:

> "§10(b) liability arises only when the alleged fraud between the parties and/or [the] alleged market manipulation or deception is intrinsic to the securities transaction itself." [Footnotes omitted] *Drachman* v. *Harvey*, Docket No. 35077, CCH Fed. Sec. L. Rep. ¶93, 129 at 91, 100, 91, 101 (2d Cir. July 21, 1971).

Thus, it is not sufficient for a plaintiff merely to allege both a fraud and a security transaction. As Judge Herlands stated in dismissing the Complaint herein:

> "A federal claim is not pleaded by allegations that, in the course of a scheme to loot a corporation of its assets, certain security transactions occurred, when these transactions—though contaminated by the overriding evil intent to accomplish the ultimate looting—did not involve fraud or deceit in connection with the sale or purchase of a security." App., p. 83a.

For a fraud to occur in connection with the purchase or sale of a security, that fraud must materially affect the purity of the security transaction or the purity of the security trading process. The wrongdoing may involve, among

other things, the terms of sale,[2] dishonesty by a broker,[3] manipulation of a market,[4] or failure to provide accurate information to the investing public.[5] But wherever the fraud occurs in the securities exchange process, it must affect a part of that process to be subject to the federal securities laws.

In this case, no injury is alleged to have occurred at any point in the securities exchange process. No participant in any securities market is alleged to have acted dishonestly; no market for any security is alleged to have been manipulated; and no security is alleged to have been sold for other than its fair value. Manhattan's Treasury bonds were delivered by Chemical Bank to Irving; they were sold through Garvin, Bantel to Second District Securities Co., Inc., a leading dealer in the government bond market; and the proceeds of $4,854,552.67 paid by Second District were credited by Irving to Manhattan's account. The alleged wrong was not in the security transaction but rather in the later misappropriation of $5,500,000 of Manhattan's funds, $4,854,552.67 of which may be traceable to the proceeds of sale of the bonds.

Petitioner has suggested two alternative times at which Manhattan funds may have been misappropriated. Under Petitioner's first theory, Manhattan was injured on January 24, 1962, when $5,000,000 of $5,004,552.67 (consisting of $4,854,552.67 deposit of proceeds of securities plus $150,000 cash deposit) in the Manhattan account at Irving were diverted by Begole to pay for the check to Bankers Life used for the purchase of the Manhattan stock. This

2. *Schoenbaum* v. *Firstbrook*, 405 F.2d 200, *rev'd en banc on other grounds*, 405 F.2d 215 (1968), *cert. denied sub nom. Manley* v. *Schoenbaum*, 395 U.S. 906 (1969).

3. *SEC* v. *Lawson*, 24 F. Supp. 360 (D. Md. 1938).

4. *Pettit* v. *American Stock Exchange*, 217 F. Supp. 21 (S.D.N.Y. 1963).

5. *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied sub nom. Kline* v. *SEC*, 394 U.S. 976 (1969).

theory has the advantage of simplicity but is inconsistent with Petitioner's second theory and certain facts admitted by Petitioner.

Under Petitioner's second theory, Manhattan was injured on January 25, 1963 when $5,500,000 of funds in its account at Belgian Trust were misappropriated; $5,250,000 of which was used to repay the Belgian Banking loans to New England and $250,000 of which was diverted by Begole and Sweeny. Under this theory, the $5,000,000 Irving check to Bankers Life was paid for by the $5,000,000 Belgian Banking check payable to Irving for the account of New England which represented the proceeds of one of the Belgian Banking loans to New England.

Also under this theory, $5,000,000 of the funds in the Manhattan account at Irving on January 24, 1962 were used by Manhatian to purchase the $5,000,000 Belgian Trust certificate of deposit issued to Manhatan on that date. The proceeds of this certificate of deposit were used on July 24, 1962 to pay for a second six-month $5,000,000 Belgian Trust certificate of deposit. Also on July 24, 1962, Manhattan's account at Belgian Trust was credited with $74,383.56 interest on the maturing certificate of deposit. In August of 1962, the Belgian Trust certificate of deposit which had been issued on July 24, 1962 was exchanged for a new negotiable Belgian Trust certificate of deposit in the same amount in the name of Manhattan, and the new certificate of deposit was delivered to Belgian Trust together with a $500,000 certificate of deposit of the First National Bank of Boston also owned by Manhattan. Both certificates of deposit were delivered on the assurance of a letter from Belgian Trust stating that they would be held in trust for Manhattan and that the proceeds would be credited to Manhattan's account on maturity. Petitioner alleges that the $5,590,977.62 principal and interest of those

two CDs were credited to a Manhattan account at Belgian Trust on January 25, 1963. He further claims that thereafter Manhattan was injured when $5,250,000 of those funds were misappropriated to repay the Belgian Banking loans to New England and $250,000 were diverted by Begole and Sweeny.

Under either theory Petitioner has alleged no more than a complicated scheme of common law fraud in which the diverted funds may be traced in part to a securities transaction. Under his first theory, the proceeds of the Manhattan Treasury bonds may be traced to a misappropriation which allegedly occurred on the same day as their sale. Under his second theory, the proceeds of the bonds may be traced to the purchase of the Belgian Trust CDs whose proceeds were eventually misappropriated. However, neither effort to trace the proceeds of Manhattan's Treasury bonds describes a fraud in connection with their sale within the meaning of the federal securities acts. The possibility that Petitioner may trace some of the converted funds to the bond proceeds does not taint the non-fraudulent sale of the bonds and cause that sale to have been "in connection with" the subsequent misappropriation within the meaning of Section 10(b).

The essence of the fraud in this case is a conversion of corporate assets. (App., pp. 84a, 89a) No fraud occurred in connection with the sale of the bonds, and thus no fraud occurred in violation of the federal securities laws.

The critical issue presented here is whether there is a limit to the concept of a fraud in connection with the purchase or sale of a security or whether any relationship—however indirect, attenuated or tangential—is sufficient to establish federal jurisdiction. Both the Congressional intent underlying the enactment of the 1934 Act and the extensive preemption of traditional state law which would result from a contrary holding compel the conclusion that

there is a jurisdictional distinction between Section 10(b) claims and non-federal anti-fraud claims. This distinction, as stated by Judge Herlands below, is that: ". . . . Rule 10(b)-5 requires the employment of fraud in connection with a security transaction, which is essentially different from the effectuation of a security transaction in connection with a fraudulent activity." (App., p. 84a)

B. Congress did not intend to regulate conduct which does not in any way affect investment decisions or the public interest in maintaining sound securities markets.

Although Section 10(b) is perhaps the most litigated provision of the federal securities laws, its draftsmen seem not to have anticipated its potential significance. It "was one of the least controversial parts of the 1934 Act", and there is a "dearth of evidence" as to the Congressional intent in enacting it. Bromberg, *Securities Law: Fraud—SEC Rule 10b-5,* Sec. 2.2. As a consequence, one can only deduce the legislative purposes for its enactment from the more abundant information available about other sections of the statute.

From the background of the 1934 Act generally and in view of the economic events which provoked its adoption, it appears that "the anti-fraud provisions were adopted to protect the trading process in the securities markets [footnote omitted], not to provide a federal remedy for every injury that might in any way be connected with a securities fraud." Boone and McGowan, "Standing to Sue under SEC Rule 10b-5," 49 Tex. L. Rev. 617, 622 (1971). As the Court of Appeals for the Second Circuit recognized:

> "The dominant Congressional purposes underlying the Securities Exchange Act of 1934 were to promote free and open public securities markets and to protect the investing public from suffering inequities in

trading. . . ." *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 858 (1968), *cert. denied*, 394 U.S. 976 (1969).

More specifically, the Fifth Circuit recently concluded that:

> "By section 10(b) Congress meant to prevent manipulation and control of the prices at which securities are bought and sold and to enable buyers, sellers, and traders of securities to make a proper appraisal of the value of securities." *Herpich* v. *Wallace*, 430 F.2d 792, 801 (5th Cir. 1970).

Notwithstanding the paucity of information as to Congressional intent in enacting Section 10(b), both Petitioner and the Securities and Exchange Commission ("SEC"), as *amicus*, have contended that legislative history sanctions an action such as this. A complete examination of the sources of legislative history cited by Petitioner and the SEC indicates that those sources do not support the proposition that conduct such as that alleged herein should constitute a fraud in connection with a securities transaction.

The overriding purpose of Congress in enacting the 1934 Act was the regulation of issuers, exchanges, brokers and speculators in order to protect participants in investment transactions and to prevent the recurrence of an economic depression. As the Court of Appeals indicated below:

> "Although in the broadest sense the public interest is involved when a corporation which is subject to regulation by the state Superintendent of Insurance is defrauded, the public interest cognizable by §10(b) is limited to preserving the integrity of the securities markets." App., p. 107a.

Congress did not intend to protect investors in all of their business transactions, but rather to provide a federal

remedy for them when they engage in a purchase or sale of securities. Congress intended to reduce the risks of dealing in securities, but did not attempt to guard against the risks of accumulating cash or owning bank accounts as a consequence of dealing in securities. Investors are afforded certain protection by Section 10(b) when they function as investors, but are not afforded this protection when they are not functioning as investors.

The consequences of this distinction are made clear in a case such as this in which the "person" dealing in securities is not an individual but rather a corporation which must act through agents who may have interests contrary to its own. When an individual purchases or sells securities, the federal courts look only to the integrity of the transaction in which he participates and to the market mechanisms and institutions by means of which the transaction occurs. Presumably, the federal interest is no broader in the case of corporations. When the individual investor disposes of a security, the federal courts do not inquire as to the use of the proceeds. Presumably, there is no greater need for federal review of the use of security proceeds by corporate investors.

Although corporate insiders have opportunities to divert for their own benefit the proceeds of corporate securities transactions, those opportunities are no greater than, and no different from, the opportunities afforded those persons to misuse other corporate assets. The mere fact that an embezzlement or misappropriation of corporate funds can be linked by some chain to a securities transaction does not change the character of that wrongful act from an embezzlement or misappropriation to a federal fraud. The Congressional purpose underlying the Securities Exchange Act was to protect the corporate investor when it functioned as such—that is, when it availed itself of brokers, exchanges, credit agencies or other instrumentalities of the

securities markets. The corporate assets resulting from such participation were not the subject of federal regulation.

C. To find a federal wrong herein would result in federal preemption of state law governing corporate mismanagement.

The alleged wrong in this action was the misappropriation of Manhattan's funds. Misappropriation of corporate assets has long been held under state law to constitute corporate waste, and state remedies are available against officers, directors and shareholders guilty of such a breach of fiduciary duty. In this case the Court must decide whether state law relating to corporate mismanagement will be preempted by judicially created federal law. If the Court decides to preempt state law and to create a federal corporate law, a substantial increase in federal court litigation will result.

The lower federal courts have concluded that such federal preemption is not warranted by either the language or the legislative history of the 1934 Act. See *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952); *Lester* v. *Preco Industries, Inc.*, CCH Fed. Sec. L. Rep. ¶91,562 (S.D.N.Y. 1965); and *Kaminsky* v. *Abrams*, 281 F.Supp. 501 (S.D.N.Y. 1968). As the court observed in *Barnett* v. *Anaconda Co.*, 238 F.Supp. 766, 770 (S.D.N.Y. 1965), in dismissing a complaint brought under both Section 10(b) and Section 17(a), the federal securities acts have not "swallowed the whole body of state statutory and common law covering the internal administration of the affairs of corporations and the fiduciary obligations of those who manage and control them."

Absent clear legislative intent, such preemption of state law and such increased burden upon the federal courts should not be sanctioned. The 1934 Act was not intended to supersede state law,[6] but rather to make avail-

6. State law was then, and is now, effectively coping with new types of corporate mismanagement. See, *e.g.*, *Diamond* v. *Oreamuno*, 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969).

able new remedies applicable to transactions in the interstate securities market. As Professor Loss has pointed out:

> "the implication of a private action under Rule 10b-5 has already displaced and federalized a great deal of state law, not only in the area of deceit but also with respect to the duties of officers and directors to the corporation and its stockholders. A District Court has recently observed in another context that, 'where effective state remedies for the conduct proscribed by the federal statute are available throughout the country, there is generally little reason to imply a federal cause of action.' Olympic Capital Corp. *v.* Newman, 276 F.Supp. 646, 657 (C.D. Cal. 1967). The very lengths to which the 10b-5 development has been carried inevitably arouse some doubt whether so marked a reform in important areas of essentially 'private' law, however, overdue it may have been, can be justified on the basis of an eight-line omnibus provision in a securities statute that gives the enforcing agency a rule-making authority to deal with types of market "shenanigans" that the draftsmen might not have dealt with specifically." 6 Loss, *Securities Regulation* 3870 (1969 Supp.)

In the context of both effective state regulation and the Congressional intent, expansion of Section 10(b) by judicial interpretation to include the misappropriation of corporate funds by corporate insiders is not justified. Such a broad expansion of the statute should be left to Congress. As the Fifth Circuit recently stated:

> "If Congress had intended that the federal courts inquire into every decision affecting the management of corporations and then fashion a new federal law superseding state law on the fiduciary responsibilities of corporate directors, officers, and controlling persons, presumably so revolutionary a federal intervention into an area traditionally handled by the states would have been clearly expressed." *Herpich* v. *Wallace,* 430 F.2d 792, 809 (5th Cir., 1970).

II.

PETITIONER CANNOT RECOVER ON BEHALF OF MANHATTAN UNDER THE FEDERAL SECURITIES LAWS BECAUSE MANHATTAN'S SOLE SHAREHOLDER AUTHORIZED AND APPROVED THE SALE OF ITS SECURITIES.

Petitioner alleges that he is suing as Liquidator of Manhattan and that as Liquidator he is vested with all rights of action of Manhattan. (Complaint ¶2; App., p. 4a; Petitioner's Brief p. 5) However, Petitioner cannot state a claim under the federal securities laws on behalf of Manhattan because Manhattan's sole security holder, defendant Begole, authorized and approved all actions taken by Manhattan relating to the purchase or sale of securities.

A corporation which sells securities cannot be injured, in its capacity as a seller, when its sole shareholder authorizes, and is aware of all circumstances surrounding, the sale transaction. All of the shareholders of a corporation constitute the corporation and consequently cannot defraud themselves by any corporate action which is ratified by them. See *Cunningham* v. *Jaffe,* 251 F. Supp. 143 (D.S.C. 1966). In *Schoenbaum* v. *Firstbrook,* 405 F.2d 215 (2d Cir. 1968) (*en banc*), *cert. denied sub nom. Manley* v. *Schoenbaum,* 395 U.S. 906 (1969), where a corporation was alleged to have issued stock to its controlling shareholder for an inadequate consideration, the Court of Appeals for the Second Circuit recognized that a Section 10(b) action could be brought on behalf of the corporation only because minority shareholders of the issuer had been deceived in connection with that sale. See 405 F.2d at 220; see also the opinion of Hays, J., dissenting to the decision of the panel in that case, at 405 F.2d 200, 215.

As the court held in *Field* v. *Lew,* 184 F. Supp. 23, 27 (E.D.N.Y. 1960), *aff'd* 296 F.2d 109 (2d Cir. 1961), *cert. denied, Field* v. *Bankers Trust Co.,* 369 U.S. 859 (1962):

> "A corporate officer who uses corporate funds for his own purposes may be liable for conversion to the

corporation and in bankruptcy to the trustee. Since the officer had no title to the property, transferees of the officer may be similarly liable. However, the general rule of liability does not apply when the officer's acts have been ratified by all the shareholders of the corporation. In that case, the unauthorized acts of the individual become the authorized acts of the corporation, the corporation loses its right of action against the officer, and the corporation, having no right, the trustee in bankruptcy also has no right. See Reif v. Equitable Life Assurance Soc'y, 1935, 268 N.Y. 269, 197 N.E. 278, 100 A.L.R. 55; Barr & Creelman Mill & Plumbing Supply Co. v. Zeller (sic), 2 Cir., 1940, 109 F.2d 924; Quintal v. Kellner, 1934, 264 N.Y. 32, 189 N.E. 770; Rosenfeld v. Fairchild Engine & Aviation (sic) Corp., 1955, 309 N.Y. 168, 180, 128 N.E.2d 291, 51 A.L.R.2d 860 (dissenting opinion); Capitol Wine & Spirit Corp. v. Pokrass, 1st Dept. 1950, 227 (sic) App. Div. 184, 98 N.Y.S. 2d 291; John William Bldg. Corp. v. Union Trust Co., 4th Dep't 1939, 256 App. Div. 885, 9 N.Y.S.2d 14; New York Credit Men's Adjustment Bureau, Inc. v. Manhattan Life Ins. Co., City Ct. N.Y. 1955, 149 N.Y.S.2d 778. Under the facts of the instant case, the corporation would have no action in conversion against Lew, any of his transferees, or any one participating in the transfer, because Lew as sole stockholder ratified his own actions."

As the *Field* case illustrates, it is important to distinguish the various capacities in which a corporate trustee or liquidating agent may act. Each capacity may provide the agent with standing to assert different causes of action, but, of course, each separate cause of action will be subject to its own defenses. The agent may bring a suit in the right of the corporation, but will be subject to the defenses and counterclaims to which the corporation would be subject. On the other hand, the agent may have the right to litigate on behalf of the creditors of the corporation as distinguished from the company itself. See, *e.g.*,

Bankruptcy Act §70e, 11 U.S.C. §110(e). In that situation, the agent would be free of defenses against the corporation but might be subject to other objections not applicable to the corporation.

In the present case, Petitioner asserts that he is litigating on behalf of Manhattan, the corporation. In that capacity he is subject to the defenses to which Manhattan would be subject. In particular, he cannot claim that Manhattan was a defrauded seller when the sole shareholder of the corporation was aware of, and in fact the planner of, the sale transaction. See *Field* v. *Lew, supra,* and 13 Fletcher, *Corporations* §§5862 and 5866 (1970 ed.).

This is not to say that the conduct of a sole shareholder in diverting to his personal use corporate funds which were generated by the sale of securities violates no law. Such conduct may constitute the payment of an illegal dividend or may violate state laws respecting creditors' rights. See opinion of Judge Herlands below, App., p. 84a; see also New York Debtor and Creditor Law §§270-281 and New York Business Corporation Law §§719, 720. But the mere fact that such conduct may otherwise be unlawful does not mean that it violates the federal securities laws. See *Iroquois Industries, Inc.* v. *Syracuse China Corporation,* 417 F.2d 963, 969 (2d Cir. 1969), *cert. denied,* 399 U.S. 909 (1970), and *Carliner* v. *Fair Lanes, Inc.,* 244 F. Supp. 25 (D. Md. 1965). Those statutes are intended to protect persons who engage in securities transactions. When the sole shareholder of a corporation authorizes the transaction in question, no federal injury can occur to the corporate "person".

A recent decision of the Court of Appeals for the Fifth Circuit, *Bailes* v. *Colonial Press, Inc.,* Docket No. 29048, CCH Fed. Sec. L. Rep. ¶93,085 (5th Cir. June 15, 1971), may be in conflict with the reasoning set forth above. In that case the court held that a federal trustee in bankruptcy stated a claim on behalf of a corporation against

corporate promoters under Section 10(b) of the Securities Exchange Act of 1934, even though at the time of the alleged fraud all of the shareholders, *i.e.*, the promoters, had approved of and participated in the corporate transaction. The court conceded that it was acting without any direct precedent and stated that if was reversing a "well-reasoned" opinion of Judge Allgood that no claim could be stated under the 1934 Act. (The opinion of Judge Allgood appears as an appendix to the *Bailes* decision at CCH Fed. Sec. L. Rep. ¶93,085 at 90,989.) As the *Bailes* case involved the liability of promoters of a newly organized corporation, it is also in direct conflict with the holding of this Court in *Old Dominion Mining and Smelting Co.* v. *Lewisohn,* 210 U. S. 206 (1908). In *Old Dominion,* the Court held that under federal common law a corporation has no cause of action against its promoters for an injury incurred in connection with the sale of its stock to the promoters when all of the shareholders participate in and ratify such sale. In short, there is no precedent for the *Bailes* decision under the federal securities laws and it would appear to be in conflict with *Old Dominion* insofar as federal common law is concerned.[7]

The error of the decision in *Bailes* that a corporate seller may recover notwithstanding ratification of the sale transaction by all shareholders is that it misinterprets the pur-

7. The *Old Dominion* decision was rendered prior to *Erie R. Co.* v. *Tompkins,* 304 U.S. 64 (1938). It was distinguished in *McCandless* v. *Furlaud,* 296 U.S. 140 (1935), where the Court held that an equity receiver suing on behalf of creditors of a corporation could assert a claim against promoters. However, the Court did not state that the corporation itself or the receiver suing on behalf of the corporation could bring such an action.

Even if the federal common law were to the contrary, it would not avail Petitioner herein as he has commenced this action solely on the basis of the federal securities laws. Petitioner's common law rights as a New York State liquidator are determined by the law of the State of New York. Moreover, the causes of action set forth in the federal Bankruptcy Act in favor of a trustee in bankruptcy do not apply to Petitioner as his capacity does not derive from that statute.

pose of the federal securities laws. Those statutes were intended to govern the integrity of securities transactions and the securities markets; they were not intended to create a new federal law of debtor and creditor rights nor a new federal law encompassing the entire area of corporate mismanagement.

The purpose of Section 10(b) can again be illustrated by considering a sale of securities by an individual. When an individual knowingly engages in a security transaction, he cannot be defrauded in connection with that transaction in violation of the federal securities laws. Consequently, no action to review that transaction may be brought under the 1934 Act by him, by his successors in interest or by a creditor or any other non-participant in the transaction. The result should be the same when all of the shareholders of a corporation knowingly ratify and affirm the corporation's participation in a security transaction.

If the Court holds that a federal claim can be stated on behalf of a corporation notwithstanding ratification of the corporate security transaction by all shareholders, there will be no finality to any security transaction by a corporation or any entity other than an individual. Since interests in corporations and other entities are transferable, any successor holder of any such interest might complain of the validity of a transaction consummated while his predecessor held his interest. Certainly as regards corporate shareholders, such a result would be contrary to the federal policy set forth in Rule 23.1 of the Federal Rules of Civil Procedure.

If this Court permits Petitioner to sue on behalf of Manhattan whose securities transactions were authorized by its sole shareholder, it will overturn long standing principles of corporation law and will intrude on state regulation of corporate mismanagement and creditors' rights. Moreover, such a decision will bring into the federal courts new

actions based on theories not contemplated by Congress and extending far beyond the intended scope of the federal securities laws. Any such creation of new rights should be left to Congress and should not be undertaken by this Court in the unusual circumstances presented herein. Consequently, Petitioner should not be permitted to bring an action under the federal securities laws on behalf of Manhattan.

III.

PETITIONER HAS NO STANDING TO SUE ON BEHALF OF MANHATTAN'S CREDITORS UNDER THE FEDERAL SECURITIES LAWS FOR JUDICIAL REVIEW OF CORPORATE SECURITIES TRANSACTIONS.

Petitioner claims to be suing on behalf of Manhattan. However, as established in Point II, *supra*, Petitioner, suing on behalf of Manhattan as a corporate seller, cannot recover under the federal securities laws because defendant Begole, its sole shareholder, authorized and participated in the corporate securities transactions.

In apparent recognition that Petitioner is foreclosed from suing on behalf of Manhattan, the SEC suggests that Petitioner might have standing to maintain this action as the representative of injured creditors and policyholders of Manhattan (Amicus Brief, p. 27). In making this suggestion the SEC indicates an unfamiliarity with the record herein. First, the policyholders of Manhattan were reinsured at the time of the liquidation. Second, Petitioner does not claim any injury to any creditor of Manhattan. Third, Petitioner does not claim to be suing on behalf of Manhattan creditors.

Assuming, *arguendo*, that a creditor of Manhattan was injured, the SEC is mistaken in concluding that creditors of a corporation—in addition to its security holders—have

standing to sue under the securities acts with respect to security transactions of the debtor corporation. Contrary to the position taken by the SEC, there is nothing in the legislative history of the federal securities laws to support the proposition that creditors of a corporation have standing to sue under those statutes. Although the SEC asserts that Congress was concerned with the protection of corporate creditors and holders of insurance policies, reference to the legislative history of the 1934 Act makes it clear that such concern was directed toward conditions in the national securities and credit markets and to the functioning of the national securities exchanges. When read in context, the SEC's citations to the legislative history do not support its position. See S.Rep. No. 1455, 73rd Cong., 2d Sess. 5 (1934) and 78 Cong. Rec. 7867-7869 (1934).

Neither case cited by the SEC (Amicus Brief, p. 28) justifies extending to creditors standing to sue under the 1934 Act. In *Pepper* v. *Litton*, 308 U.S. 295 (1939), a bankruptcy case not involving the federal securities laws, the Court held that a trustee under the Bankruptcy Act could enforce for the benefit of creditors the fiduciary obligations of a director or dominant stockholder. *Hooper* v. *Mountain States Securities Corp.*, 282 F.2d 195 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961), was an action by a trustee in bankruptcy brought on behalf of a publicly-held corporation, and the trustee represented the corporation and its public shareholders as well as its creditors. There could be no claim that all of the shareholders therein had ratified the corporate securities transactions. As Judge Herlands indicated in distinguishing *Hooper*, the "scheme [in that case] indeed an unfair sale of securities and it had as a major purpose the spread of watered stock to many investors." (App., p. 87a)

In support of its position that creditors have standing to sue under the securities acts the SEC states that it

has long been recognized that controlling shareholders owe a duty to corporate creditors. No citation in support of this proposition is given, apparently because any such citation would have to be to state law which provides corporate creditors with ample remedies against dishonest officers, directors and shareholders.[8] The absence of effective state remedies for participants in the national securities markets necessitated the enactment of the federal securities laws; however, the existence of effective state remedies made it unnecessary for Congress to create new rights for creditors and make it unnecessary for this Court to create such remedies under Section 10(b). As the Court of Appeals below indicated:

> "(W)e do not decide that the creditors of Manhattan do not have any remedy under general state tort law for the fraud practiced on their debtor, but only that the federal Securities Acts have not provided a federal forum for its enforcement." App., p. 107a.

Although the SEC asserts[9] that this Court need not reach the question of the validity of the limitation established in *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2nd Cir.), *cert. denied*, 343 U.S. 956 (1952), that only a purchaser or seller of securities may maintain an action for damages under Section 10(b), it fails to recognize that the validity of the purchaser-seller doctrine must be reviewed by the Court if it considers the question of Petitioner's standing to sue on behalf of Manhattan's creditors. *Birnbaum* will be seriously eroded if Petitioner is permitted to maintain this action on behalf of creditors, who were neither pur-

8. *See e.g.*, New York Business Corporation Law, Sections 719 and 720; *New York Credit Men's Adjustment Bureau, Inc.* v. *Weiss*, 305 N.Y. 1, 110 N.E. 2d 397 (1953); and New York Debtor and Creditor Law, §§270-281.

9. The SEC concedes that the Court does not have to review the *Birnbaum* rule in determining Petitioner's standing to sue in connection with the sale of Manhattan's capital stock. Amicus Brief, p. 7, fn. 6.

chasers nor sellers of any of the securities involved in this action.

The *Birnbaum* holding has been uniformly and repeatedly followed by every Circuit considering the issue. See *Greenstein* v. *Paul*, 400 F.2d 580 (2d Cir. 1968); *Herpich* v. *Wallace*, 430 F.2d 792 (5th Cir. 1970); *Mader* v. *Armel*, 402 F.2d 158 (6th Cir. 1968), *cert. denied sub nom. Young* v. *Mader*, 394 U.S. 930 (1969); *Dasho* v. *Susquehanna Corp.*, 380 F.2d 262 (7th Cir.), *cert. denied sub nom. Bard* v. *Dasho*, 389 U.S. 977 (1967); *The Greater Iowa Corp.* v. *McLendon*, 378 F.2d 783 (8th Cir. 1967); and *Erling* v. *Powell*, 429 F.2d 795 (8th Cir. 1970).

In 1969, the Court of Appeals for the Second Circuit reviewed and reaffirmed the purchaser-seller requirement in *Iroquois Industries, Inc.* v. *Syracuse China Corp.*, 417 F.2d 963 (2d Cir. 1969), *cert. denied*, 399 U.S. 909 (1970):

> "The *Birnbaum* rule recognizes the policy of Congress in enacting Section 10(b) and of the Commission in adopting Rule 10b-5, namely, the protection of defrauded purchasers and sellers. It is not the province of the courts to extend Section 10(b) to apply to transactions not intended to be covered by Congress. We do well to heed the words of Mr. Justice Black, writing for the Court in a case about another section of the 1934 Act, *Blau* v. *Lehman*, 368 U.S. 403, 413, 82 S. Ct. 451, 457, 7 L. Ed. 2d 403 (1962):
>
> > 'Congress can and might amend [the Act] if the Commission would present to it the policy arguments it has presented to us, but we think that Congress is the proper agency to change an interpretation of the Act unbroken since its passage, if the change is to be made.'" 417 F.2d at 969.

In the context of a judicially created cause of action, and in the absence of clear Congressional intent, a doctrine as

long established as *Birnbaum* should not be overruled in order to give creditors or their representatives standing to sue under Section 10(b).

The legislative history of the securities laws, the decisions rendered thereunder and the adequate remedies available to creditors under state law all support the proposition that a creditor who is not a security holder of his debtor should not have standing to obtain review of corporate securities transactions. Dramatic practical consequences would follow if this Court were to hold to the contrary. If Petitioner is permitted to maintain this action on behalf of creditors, then any creditor will have standing under the federal securities acts to object to any security transaction of its debtor. In the case of a corporate debtor, any creditor might challenge any decision of management to issue, purchase or sell any security. Even the most routine corporate transaction would be subject to the scrutiny of the federal courts at the request of a litigious creditor. Indeed, creditor actions might be brought notwithstanding the decisions or interests of the corporation's shareholders. Such a federal incursion upon state law governing the management of corporations and the relationship of creditor and debtor should not result in the absence of clear Congressional intent. It certainly should not arise from the judicial creation of a private remedy by inference from the very general anti-fraud provisions of Section 10(b).

CONCLUSION

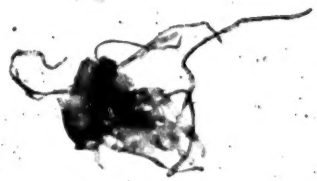
The judgment of the Court of Appeals should be affirmed.

Respectfully submitted,

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Dated: August 30, 1971



ATTACHMENT A

STATEMENT OF FACTS

The courts below considered the motions to dismiss the Complaint, the final resolution of which is now on review before this Court, not only on the basis of the allegations of the Complaint but also with regard to additional claims set forth by Petitioner in his briefs and in oral argument. In an attempt to give the Court as clear a picture as possible of what Petitioner has claimed throughout the course of this litigation, this "Statement of Facts" also refers to claims made by Petitioner which do not appear in the Complaint.[10] It should be understood that a reference in this brief to any assertion by Petitioner does not mean that the Respondent Irving admits that any such claim is true.

Petitioner alleges that as of the autumn of 1961, Manhattan was wholly-owned by defendant Bankers Life. (C. ¶17; App., p. 7a) At that time Bankers Life made two decisions which led to the events of this case. It released defendant Sweeny as President of Manhattan (CAB, p. 5), and it determined to sell its interest in that company. After his discharge, Sweeny introduced the defendants Bourne and Begole, prospective purchasers of Manhattan, to James W. Bourland, a Vice-President of Bankers Life charged with arranging the sale of Manhattan. (App., p. 52a) Although it is not alleged in the Complaint, Judge Herlands assumed that at this time Sweeny came to an agreement with Begole

10. For purposes of this Attachment, the following abbreviations are used in references to the Record: "C"—Complaint in this action; "DCB"—Petitioner's Brief to the District Court for the Southern District of New York; "CAB"—Petitioner's Brief to the Court of Appeals for the Second Circuit; "Pet."—the Petition for a Writ of Certiorari; "P.B."—Petitioner's Brief to this Court on the merits; and "St. C."—Complaint in Petitioner's action in the Supreme Court of New York County. For the full names of persons and entities referred to herein, see pp. 1 and 2, *supra*.

and Bourne that he would be reinstated as President of Manhattan when, and if, they acquired control of the company. (App., 52a; see CAB, p. 5) Negotiations which commenced in November of 1961 led to a contract for the purchase and sale of the Manhattan shares which was executed by Bankers Life and Begole on January 19, 1962. (C. ¶19, 20; A. p., p. 7a; DCB, p. 8) Begole agreed to deliver to Bankers Life, at a closing to be held on January 24, 1962, a bank check or certified check in the amount of $5,000,000. (C. ¶20; App., p. 7a) The Complaint does not charge any misrepresentation, deceit or non-disclosure in connection with this contract of purchase and sale.

Some time after January 19, 1962, but prior to the closing date, Bourne informed Begole that he would obtain financing for the stock acquisition. (C. ¶21; App., p. 8a) Bourne contacted defendant Garvin, a partner in the defendant brokerage firm Garvin, Bantel, and asked Garvin to arrange with a bank to issue a $5,000,000 certificate of deposit and to grant a loan in the same amount secured by that certificate. (C. ¶21, 22; App., p. 8a; see DCB, pp. 7-9) Acting upon Bourne's request, Garvin arranged for Belgian Trust to issue a $5,000,000 certificate of deposit in the name of Manhattan. (C. ¶23; App., p. 8a) Garvin also asked Belgian Banking to loan $5,000,000 to the defendant New England, a company controlled by Bourne, upon the security of the Belgian Trust certificate of deposit to be issued in the name of Manhattan. (C. ¶23; App., p. 8a) On January 23, 1962, in final preparation for the closing, Garvin asked Gunter, an Assistant Secretary of defendant Irving, to appear at his office the next morning with an Irving check for $5,000,000 payable to Bankers Life. Garvin informed Gunter that the check would be paid for by the delivery of securities from Chemical Bank New York Trust Company. (C. ¶24; App., p. 8a)

Events of January 24, 1962

On the morning of January 24, 1962, Bourne, Sweeny, Begole and Gunter assembled at Garvin's office. Begole then executed two notes totaling $5,250,000 payable to New England. At the same time, Begole assigned to New England the shares of the Manhattan capital stock that he was to receive from Bankers Life. (C ¶25; App., p. 8a)

Later that same morning, Sweeny, Begole, Garvin and Gunter went to the offices of Manhattan for the closing of the sale of the Manhattan stock. There, Gunter delivered a $5,000,000 Irving check to Leo Lehane, an Executive Vice-President of Bankers Life. (C. ¶26; App., p. 9a; Pet., p. 6; DCB, p. 9; CAB, p. 9) Although the Complaint does not so state, Judge Herlands assumed that Begole did obtain possession of the Manhattan stock. (App., p. 55a; see C. ¶28, 38; App., pp. 9a-10a, 12a)

Following the closing, Begole, the new sole shareholder of Manhattan, installed a new Board of Directors for the company. (CAB, p. 18) All previous officers resigned or were removed, and the new Board unanimously elected a new slate of officers which included Begole as Chairman of the Board and Sweeny as both President and Treasurer. (Bankers Life Exhibit 7-H; see CAB, p. 5; Pet., p. 8 and P.B., p. 7) The new Board then adopted resolutions (App., p. 122a; Bankers Life Exhibit 7-H) which authorized:

1. President to open bank accounts of his choosing, including accounts at Irving;

2. Appropriate officers to be signatories on such accounts;

3. President and Secretary to take all necessary acts to effectuate intent of the above resolutions;

4. Sale of Manhattan's portfolio of Treasury securities; and

5. Purchase of a $5,000,000 certificate of deposit from Belgian Trust.

All of the above resolutions were submitted to the Board by Begole, and, as no dissenting votes are indicated, must have been passed unanimously. (See App., p. 122a; Bankers Life Exhibit 7-H)

Subsequent to the Directors' meeting, United States government securities were delivered from Chemical Bank to Irving. (CAB, p. 26) The securities were sold by Garvin, Bantel for the account of Manhattan to Second District Securities Co., Inc. The securities were delivered to the purchaser, and Irving credited the $4,854,552.67 proceeds of sale to Manhattan's account at Irving. (C. ¶27; App., p. 9a) Irving also received a $150,000 check of Manhattan for deposit to Manhattan's account. (CAB, p. 27) The Manhattan account at Irving allegedly was not opened until the afternoon of January 24, 1962. (C. ¶30; DCB, p. 10; CAB, p. 10; Pet., p. 9; P.B., p. 8)

Also on January 24, 1962, at the request of Garvin, Gunter brought to the offices of Belgian Trust an Irving check payable to Belgian Trust in the amount of $5,000,000. Gunter gave this check to Sweeny who in turn delivered it to Belgian Trust on behalf of Manhattan. Pursuant to Garvin's prior discussion with the bank, Belgian Trust then issued a six month $5,000,000 certificate of deposit in the name of Manhattan and accepted the Irving check in payment for it. Both Sweeny, as President of Manhattan, and Manhattan's Assistant Treasurer endorsed the certificate of deposit to New England. Bourne, as President of New England, accepted the certificate of deposit from Sweeny, and, in turn, endorsed it to Belgian Banking. (C. ¶28; St. C. ¶27; App., pp. 9a, 129a-130a; DCB, pp. 9-10; CAB, p. 10; Pet., p. 8; P.B., pp. 7-8; Plaintiff's Exhibit 10-A)

Belgian Banking then extended two loans to New England aggregating $5,250,000. One loan was for $5,000,000, and as collateral for this loan Belgian Banking took possession of the Belgian Trust certificate of deposit which had

been endorsed by Manhattan and then by New England. The second loan was for $250,000, and as collateral Belgian Banking took possession of the outstanding Manhattan stock which had been assigned to New England by Begole. In payment of the first loan, Belgian Banking drew a $5,000,000 check payable to Irving for the account of New England and delivered it to Gunter. The $250,000 proceeds of the second loan were deposited by New England in an account at Belgian Trust and were distributed, in part, as follows: to Garvin, Bantel—$25,000; to Begole—$50,000; to Bourne—$50,000; and to Belgian Banking—$100,000. (C. ¶¶28, 29; App., pp. 9a-10a; DCB, p. 10; CAB, p. 10; Pet., pp. 8-9; P.B., pp. 7-8) These various payments aggregate $5,225,000, and neither the Complaint nor any of Petitioner's briefs contain any allegation as to the disposition of the final $25,000 of the Belgian Banking loans to New England.

Later Events of 1962

By January 29, 1962, Irving is alleged to have made certain misleading entries on its own books, and Garvin is accused of obtaining backdated letters signed by Bourne. (C.¶¶ 31, 32; App., p. 10a; DCB, p. 10; CAB, p. 10; Pet., p. 9; P.B., p. 8)

On July 24, 1962, the various six-month arrangements entered on January 24 expired. The Belgian Trust certificate of deposit matured; the loans by Belgian Banking to New England became payable; and the loans by New England to Begole were due. (DCB, p. 10; Pet. p. 9; P.B., p. 8; St.C. ¶31; App., p. 131a). The Complaint and Petitioner's briefs have alleged that the response of Begole, Bourne, Garvin, Bantel, Belgian Trust and Belgian Banking was to renew these arrangements. (C. ¶33; App., pp. 10a-11a; St.C. ¶31; App., p. 131a; Pet., p. 9; P.B., pp. 8-9) $74,383.56 interest on the Belgian Trust CD was credited

to Manhattan's account at Belgian Trust (See Plaintiff's Exhibit 179 and Exhibit D to Brief of Irving to Second Circuit), and the proceeds of that CD were used to purchase a new Belgian Trust $5,000,000 CD for Manhattan. (C. ¶33; App., p. 10a-11a; DCB, p. 10; CAB, pp. 10 and 46; Pet., p. 9; P.B., p. 9) This certificate was delivered to Sweeny and was kept in his own physical possession. (CAB, p. 46; Pet., p. 10; P.B., p. 9) Finally, the Belgian Banking loans to New England were extended to January 24, 1963, and New England's loans to Begole were continued to January 24, 1963. (C. ¶33; App., p. 10a-11a; CAB, p. 47; Pet., p. 9; P.B., pp. 8-9)

In August of 1962, Sweeny allegedly returned to Belgian Trust the CD he had been holding, and was issued a second CD also in the name of Manhattan. (Pet., p. 10; P.B., pp. 9-10) Sweeny endorsed this new negotiable certificate on behalf of Manhattan, and delivered it to Belgian Trust together with instructions to deposit its proceeds upon maturity in Manhattan's account at Belgian Trust. (C. ¶34; App., p. 11a) Sweeny delivered that CD on the assurance of a letter stating that it would be held in trust for Manhattan. (CAB, p. 47; Pet., p. 10; P.B., pp. 9-10) Belgian Trust allegedly had issued that letter because Belgian Banking had received a separate letter from Begole authorizing it to treat the new CD, once endorsed by Sweeny, as collateral for the Belgian Banking loans to New England. (Pet., p. 10; P.B., p. 10; St.C. ¶31; App., p. 131a)

At the same time Manhattan also transmitted a $500,000 First National Bank of Boston certificate of deposit to Belgian Trust. This CD was delivered pursuant to the same letter from Belgian Trust which stated that it would hold the certificates in trust. (C. ¶34; App., p. 11a; St. C. ¶69; App., p. 139a; Pet., p. 10; P.B., pp. 9-10)

Events of 1963

In January of 1963, Belgian Banking allegedly indicated that it would not renew its loans to New England which fell due on January 24, 1963. (C. ¶35; App., p. 11a; DCB, p. 11; CAB, p. 11) In response to this information, Bourne and Begole initiated another series of transactions. (App., p. 60a)

First Transaction of January, 1963

On January 21, 1963, Begole, at the request of Bourne and Garvin, instructed Irving to issue $5,500,000 in bearer certificates of deposit for the account of Manhattan and directed that they be delivered against payment to Garvin, Bantel. On January 22, 1963, Marine Midland Trust Company of New York loaned Garvin, Bantel $5,500,000 on the security of the Irving bearer CDs, and the proceeds of this loan were delivered to Irving in payment for those bearer CDs. (St. C. ¶34; App., p. 132a) The Irving certificates of deposit were delivered to Marine Midland and were held as collateral for the loan to Garvin, Bantel. (Pet., p. 12; P.B., p. 11) The effect of this transaction was to create a $5,500,000 Manhattan deposit on the books of Irving. However, the negotiable certificates of deposit underlying this deposit were pledged to Marine Midland as security for its loan to Garvin, Bantel, which loan had been used to effectuate payment for the certificates of deposit.

Second Transaction of January, 1963

On January 23, 1963, Sweeny, Begole, Garvin and an officer of Belgian American agreed that the proceeds of Manhattan's $5,000,000 Belgian Trust CD and $500,000 First National Bank of Boston CD would be used to repay the New England loans at Belgian Banking. (St. C. ¶35; App., 132a)

On January 25, 1963, Belgian Trust credited Manhattan's account with $5,590,977.62: $5,075,616.44 of which represented the principal of and interest on the $5,000,000 Belgian Trust certificate of deposit, and $515,361.18 of which represented the principal of and interest on the $500,000 First National Bank of Boston certificate. (C. ¶37; DCB, p. 11; CAB, p. 11) Then, Belgian Trust issued a $5,500,000 check payable to Irving and charged this check against Manhattan's account. (C. ¶37, DCB, p. 11; CAB, p. 11; Pet., p. 12; P.B., p. 11) Irving, at the direction of Garvin, Bantel, issued its check to Belgian Banking in the sum of $5,250,000. The $5,500,000 Belgian Trust check payable to Irving and the $5,250,000 Irving check payable to Belgian Banking were exchanged at Belgian American on January 25, 1963. Belgian Banking applied the Irving check in payment of its $5,250,000 loans to New England. (C. ¶37; App., p. 12a; St.C. ¶36; App., p. 132a) At the direction of Garvin, Bantel, Irving credited the $5,500,000 check payable to it to the account of Garvin, Bantel at Irving and debited its $5,250,000 check payable to Belgian Banking to the same account. (St.C. ¶36; App., p. 132a; Pet. p. 12; P.B., pp. 11-12)

Later, Garvin drew a check for $250,000 representing the difference between the credit and debit to the Garvin, Bantel account at Irving and sent it to the Belgian American Banks. There Begole and Sweeny opened a special suspense account to hide those funds. (CAB, p. 49) Although Petitioner fails to disclose the fact in the Complaint or any of his briefs, Belgian American delivered those funds to Petitioner after Manhattan had been placed in liquidation.

Final Transactions of 1963

The Complaint alleges that two additional transactions occurred before the alleged fraud was discovered. First, on April 18, 1963, Belgian Banking returned to Begole and

Sweeny the shares of Manhattan stock which it had received as collateral for its loans to New England. (C. ¶38; App., p. 12a) Secondly, for the purpose of concealing the reduction in Manhattan's assets, Irving allegedly certified to the New York State Insurance Department on May 15, 1963, that Manhattan had on deposit at Irving the sum of $5,500,000 as evidenced by certificates of deposit issued on January 21, 1963. The certification included a statement that the certificates of deposit were free of all liens, claims, or encumbrances and were not held as security for any loan. (C. ¶39; App., pp. 12a-13a)

On or about August 22, 1963, Marine Midland Trust Company applied the proceeds of the $5,500,000 Irving CDs, which had been issued on January 21, 1963, to the repayment of its $5,500,000 loan to Garvin, Bantel secured by those CDs. (St.C. ¶39; App., p. 133a)

Conclusion

The alleged consequence of these seemingly disparate transactions which occurred during an eighteen month period was that the purchase of Manhattan was financed by its own assets. Petitioner has suggested two alternative times at which Manhattan funds may have been misappropriated. Under Petitioner's first theory, Manhattan was injured on January 24, 1962, when $5,000,000 of $5,004,552.67 (consisting of $4,854,552.67 deposit of proceeds of securities plus $150,000 cash deposit) in the Manhattan account at Irving were diverted by Begole to pay for the check to Bankers Life used for the purchase of the Manhattan stock. This theory has the advantage of simplicity but is inconsistent with Petitioner's second theory and certain facts admitted by Petitioner.

Under Petitioner's second theory, Manhattan was injured on January 25, 1963, when $5,500,000 of funds in its account

at Belgian Trust were misappropriated; $5,250,000 of which was used to repay the Belgian Banking loans to New England and $250,000 of which was diverted by Begole and Sweeny. Under this theory, the $5,000,000 Irving check to Bankers Life was paid for by the $5,000,000 Belgian Banking check payable to Irving for the account of New England which represented the proceeds of the Belgian Banking loan to New England.

Also under this theory $5,000,000 of the funds in the Manhattan account at Irving on January 24, 1962 were used by Manhattan to purchase the $5,000,000 Belgian Trust certificate of deposit issued to Manhattan on that date. The proceeds of this certificate of deposit were used on July 24, 1962 to pay for a second six-month $5,000,000 Belgian Trust certificate of deposit. On the same day Manhattan's account at Belgian Trust was credited with $74,383.56 interest on the maturing certificate of deposit. In August of 1962, the Belgian Trust certificate of deposit which had been issued on July 24, 1962 was exchanged for a new negotiable Belgian Trust certificate of deposit in the same amount, and the new certificate of deposit was delivered to Belgian Trust together with a $500,000 certificate of deposit of the First National Bank of Boston also owned by Manhattan. Both certificates of deposit were delivered on the assurance of a letter from Belgian Trust stating that they would be held in trust for Manhattan and that the proceeds would be credited to Manhattan's account on maturity. Petitioner alleges that the $5,590,977.62 principal and interest of those two CDs were credited to a Manhattan account at Belgian Trust on January 25, 1963. He further claims that thereafter $5,250,000 of those funds were misappropriated to repay the Belgian Banking loans to New England thereby injuring Manhattan.

SUPREME COURT, U. S.

No. 70-60

Supreme Court, U.S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1971

Superintendent of Insurance of the State of New York, as Liquidator of MANHATTAN CASUALTY COMPANY,

Petitioner,

versus

BANKERS LIFE AND CASUALTY COMPANY, ET AL.,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF FOR PETITIONER

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Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF FOR PETITIONER.

Argument

I.

The mere fact that the sole shareholder of a corporation participates in a securities fraud on the board of directors does not prevent a liquidator from suing on behalf of the insolvent corporation under Section 10(b).

Respondents have argued that because there was but a single stockholder of Manhattan who participated in and ratified the fraud, the petitioner may not maintain a cause of action under Section 10(b). (See e.g. B.L. br. at 12; I.T.

br. at 18-20; B.A. br. at 26-29).* The authorities relied on by respondents do not support this argument.

In *Field* v. *Lew,* 184 F. Supp. 23 (E.D.N.Y. 1960) *aff'd. sub nom' Field* v. *Bankers Trust Co.,* 296 F.2d 109 (2nd Cir. 1961), cert. denied, 369 U.S. 859 (1962), a case heavily relied on by respondents, the District Court held that a corporation has no right of action *in conversion* based upon a fraud by its president and sole stockholder because he ratified the fraud. In affirming the District Court, the Court of Appeals in *Field* v. *Bankers Trust Co., supra,* did not consider this specific holding. It must be noted that the *Field* case involved state common law, did not involve a fraud in connection with a securities transaction, and had nothing to do with Section 10(b) or any other section of the federal securities acts. That case presented no allegations of deceit and material misrepresentations made to the board of directors, which is a material allegation of this Section 10(b) action. For the same reason, *Cunningham* v. *Jaffe,* 251 F. Supp. 143 (D.S.C. 1966) and *General Hatters Supply Co.* v. *Hartman,* 148 N.Y.S. 2d 90 (Sup Ct., N.Y. Co. 1955), also relied on by respondents, are inapplicable to the instant case.

In the only Section 10(b)5 case to consider the question of corporate estoppel resulting from shareholder ratification, the Court of Appeals for the Fifth Circuit recently held in a well reasoned opinion that a trustee in bankruptcy is not estopped from suing on behalf of the corporation where all of the stockholders, directors and officers ratified the fraud by means of their participation in it. *Bailes* v.

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* The briefs of respondents are referred to herein as follows: Bankers Life and Casualty Company, B.L.; Irving Trust Company, I.T.; Belgian-American Banking Corporation and Belgian-American Bank and Trust Company, B.A.; George K. Garvin and Garvin Bantel & Company, G.

Colonial Press, Inc., 444 F.2d 1241 (5th Cir. 1971). Contrary to respondents' contention that the Court of Appeals for the Fifth Circuit cited no authority for the trustee's right to sue (B.A. br. at 28) and that *Bailes* was in conflict with federal common law as enunciated in *Old Dominion Copper Mining and Smelting Co.* v. *Lewisohn*, 210 U.S. 206 (1908) (I.T. br. at 21), we note that the *Bailes* decision relied on the holding in *McCandless* v. *Furland*, 296 U.S. 140 (1935), which in effect overruled *Old Dominion*. See dissenting opinion at 296 U.S. 173. *McCandless* held that the receiver of a bankrupt corporation had standing to recover for the unlawful depletion of corporate assets whereby the company was made insolvent and the creditors were defrauded of their lawful rights and remedies. The defendants there were the promoters and sole shareholders.

Mr. Justice Cardozo, writing for the Court, set forth the following language which disposes of the argument advanced by respondents:

> "It was not within the power of the shareholders to legalize this waste to the detriment of others. It would not have been within their power to bring that result to pass, though shareholders and promoters had been different persons, acting at arm's length. Still more clearly it was not within their power when shareholders and promoters were in substance the same persons. Cf. *California-Calaveras Mining Co.* v. *Walls*, 170 Cal. 285, 299, 149 P. 595; *Pittsburgh Mining Co.* v. *Spooner*, 74 Wis. 307, 42 N.W. 259, 17 Am. St. Rep. 149. Consent in such conditions, so far as it gives approval to conduct in fraud of the rights of others, is a word and nothing more. It is not in concord with realities." *McCandless, supra*, 296 U.S. at 160.

The consent of shareholders can never be operative where the consent is in derogation of the public policy of the State

or the prohibition of a statute. *McCandless, supra,* 296 U.S. at 162. Any alleged consent by the sole shareholder of Manhattan was in derogation of the prohibition against fraud in connection with the purchase or sale of a security contained in Section 10(b).

II.

Petitioner has standing to sue under Section 10(b) on behalf of the defrauded corporation and on behalf of its creditors and policyholders.

In *Bailes, supra,* defendants incorporated American Publishing Company and caused it to issue to them (through Colonial Press, Inc., their wholly owned corporation) 412,000 shares of stock for essentially valueless consideration. The stock was then registered with Alabama's Securities Commission and sold to the public. There were many instances of overstatement of assets and understatement of liabilities. The Court held that the trustee in bankruptcy on behalf of the corporation could maintain a 10b-5 action if acts it was caused to perform operated as a fraud or deceit upon itself or upon others—including subsequent creditors or subsequent holders of claims for taxes. *Bailes,* 444 F.2d at 1246.

The record demonstrates the manner in which Manhattan, through its board of directors, was defrauded. But petitioner also has standing to sue on behalf of Manhattan because the creditors of Manhattan were deceived within the meaning of Section 10(b). The opinion in *Bailes* is particularly appropriate:

> "It could be anticipated that, in reliance on these misrepresentations, some of these persons would extend credit in one form or another to American South-

> ern which they might well have refrained from extending had they known the true state of the corporation's finances. *The corporation was thereby exposed to the risk that it would be caused to assume liabilities to creditors which, but for the misrepresentations, it would not have assumed, and which ultimately it would be unable to satisfy due to the absence of the $412,000.00 it was represented to, but did not, possess.*" *Bailes, supra,* 444 F.2d at 1245-1246 [emphasis added].

Potential creditors and policyholders of Manhattan were justified for over one year in believing that Manhattan had a net worth which included the $5,500,000.00 it was misrepresented to have deposited with Belgian Trust. Manhattan was therefore exposed to the same risk as the corporation in *Bailes, supra,* in that it would be caused to assume liabilities to creditors which, but for the misrepresentations, it would not have assumed and which ultimately it was unable to satisfy.

Petitioner further maintains that, looking at the entire scheme, Manhattan was the victim of fraud in connection with the purchase or sale of securities. Since Manhattan was fraudulently purchased with its own assets (the proceeds from the sale of the Treasury bonds), Manhattan was a constructive purchaser of its own stock. As Judge Hays stated in dissent:

> "Since the vital center of the scheme, the vehicle for the perpetration of the fraud, was the sale of Manhattan's stock [to Begole], it seems to me to be completely unrealistic to say that the fraud was not committed 'in connection with the purchase or sale of any security' ". *Superintendent of Insurance v. Bankers Life and Casualty Co.,* 430 F.2d 355, 362.

Reliance by Irving Trust on *Schoenbaum* v. *Firstbrook,* 405 F.2d 215 (2d Cir. 1968) (en banc) cert. denied *sub nom. Manley* v. *Schoenbaum,* 395 U.S. 906 (1969) (I.T. br. at 15) for the proposition that one requirement of a corporate 10(b)5 action is shareholder injury was misplaced where, as here, the board of directors was deceived. Both the panel and the en banc decisions in *Schoenbaum* recognized that if the board of directors were deceived, a corporate cause of action existed. In *Schoenbaum,* however, no director was deceived, thereby distinguishing it from the case at bar.

Respondents incorrectly assert that petitioner is not suing on behalf of Manhattan's creditors and that petitioner does not claim any injury to any creditor of Manhattan. (See I.T. br. at 23; B.L. br. at 13, 17; B.A. br. at 16, n 3, 26, 28). Respondents have been on notice, at least since 1968, in a proceeding before the District Court, that petitioner sues on behalf of Manhattan and its creditors and policyholders See plaintiff's memorandum in opposition to motions pursuant to Rules 12(c) and 12(h) of the Federal Rules of Civil Procedure (Record, Document No. 441) at 3, 20, 34, 42-43, 48. Indeed, this fact is admitted by Bankers Life in its brief at page 13.

The Superintendent of Insurance of the State of New York is charged with:

> "The preservation and enhancement of Company assets to the end that the interests of all of its creditors, policyholders, stockholders and the public be subserved." *Knickerbocker Agency* v. *Holz,* 4 N.Y. 2d 245, 253, 173 N.Y.S. 2d 602, 609 (1958).

The provisions of the New York State Insurance Law for the liquidation of insolvent companies are exclusive in their operation and are designed to furnish a complete procedure for the protection of all parties. New York Insur-

ance Law, Art. V, Section 93; Art. XVI, Section 510, *et seq.; In re Lawyer's Title & Guaranty Co.*, 254 App. Div. 491, 5 N.Y.S. 2d 484 (1938), reargument denied, 9 N.Y.S. 2d 126 (1938). The petitioner represents the creditors and policyholders of Manhattan and will prove at trial injury to them resulting from respondents' fraud. It is unnecessary to discuss at this time the extent of damages to the creditors of Manhattan. Petitioner has established its case by showing that the votes necessary to authorize the sale of the bonds were obtained by means of materially misleading representations. That is sufficient to defeat the motion. The question of relief and the extent of damages is to be determined by the District Court at trial. *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375, 384, 386-389 (1970).

When a bankruptcy trustee sues on behalf of a corporation, he also sues on behalf of its creditors. In both *Hooper* v. *Mountain States Securities Corp.*, 282 F.2d 195 (5th Cir. 1960), cert. denied, 365 U.S. 814 (1961), and *Bailes, supra,* the Court of Appeals for the Fifth Circuit permitted trustees in bankruptcy to sue under Section 10(b) on behalf of the defrauded corporation where the creditors of that corporation would be the direct beneficiaries of any recovery obtained by the trustee. See also, *Pettit* v. *American Stock Exchange*, 217 F. Supp. 21 (S.D.N.Y. 1963). Likewise, the petitioner is entitled to recover on behalf of Manhattan under Section 10(b) where its creditors and policyholders will benefit from the recovery.

Trustees in bankruptcy have successfully sued under Section 10(b) on behalf of defrauded corporations apart from the rights of any minority shareholders to sue. *Bailes, supra; Hooper, supra; Pettit, supra.* The courts have recognized that although the corporate cause of action could be prosecuted without the benefits extended by

the Exchange Act, the procedural and jurisdictional difficulties in connection with such an action would be many and could easily frustrate effective recovery by the insolvent estate. *Hooper, supra,* 282 F. 2d at 201; *Pettit, supra,* 217 F. Supp. at 28.

That petitioner has standing to sue on behalf of the corporation in connection with the sale of Treasury bonds was recognized in the Court of Appeals. Petitioner has established his standing to sue on behalf of the corporation in connection with the purchase and sale of Manhattan stock. In addition, petitioner has standing to sue on behalf of the creditors of Manhattan. See petitioner's main brief at 29-35 and the brief for the Securities and Exchange Commission as *amicus curiae* at 26-29.

III.

Reply to misstatement of fact contained in the brief of Garvin, Bantel and Company and George K. Garvin.

The briefs of respondents contain various misstatements of fact. Petitioner deems it essential to point out the most glaring inaccuracy so that the correct record of events is before the Court.

The brief of Garvin, Bantel concedes at 3 the logic and merit of petitioner's argument concerning the deceit practiced on the board of directors of Manhattan. It then contends that the argument is inconsistent with the factual allegations—that in petitioner's state court complaint at A.128a it is alleged that Begole appointed all the members of the board and therefore the board was not an independent decision making body rendering any deception on it of no practical effect. Nowhere on the page Garvin, Bantel cites to is there a reference to any ap-

pointments of directors to the board. The state complaint referred to alleges at A.129a that Begole and Sweeny were elected directors and nothing more. Furthermore, if the board of directors was a rubber stamp of Begole's, it would have been unnecessary to fraudulently induce it by misrepresentations to authorize the sale of portfolio bonds. We respectfully direct the Court's attention to the testimony of the directors of Manhattan and other exhibits set forth at A.115a-123a. Those pages clearly demonstrate the deception practiced on the board of directors of Manhattan in connection with the sale of its portfolio of bonds.

CONCLUSION

For all of the reasons set forth herein, in petitioner's main brief, and in the brief for the Securities and Exchange Commission as *amicus curiae*, the decision of the Court of Appeals should be reversed.

Respectfully submitted,

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SUPERINTENDENT OF INSURANCE OF NEW YORK *v.* BANKERS LIFE & CASUALTY CO. ET AL.

CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

No. 70–60. Argued October 13, 1971—Decided November 8, 1971

Petitioner, liquidator of Manhattan Casualty Co., alleged that the company was defrauded, in violation of federal securities laws, by a fraudulent sale of securities owned by it. Manhattan's sole stockholder agreed to sell all of its Manhattan stock to one Begole for $5 million. Begole conspired with others to use United States Treasury bonds owned by Manhattan to pay for the shares. Through a deceptive device the bonds were sold and the proceeds used in the purchase of the stock. The depletion of Manhattan's assets was concealed by the purported transfer to it, in exchange for the proceeds of the bond sale, of a certificate of deposit which in fact had been assigned by Manhattan's new president, a co-conspirator, to another corporation and by it used as collateral for a loan. The District Court dismissed the complaint and the Court of Appeals affirmed, finding that "no investor [was] injured" and that the "purity of the security transaction and the purity of the trading process were unsullied." *Held:* Section 10 (b) of the Securities Exchange Act of 1934 makes it unlawful to use "in connection with the purchase or sale" of any security "any manipulative or deceptive device or contrivance" in contravention of the Securities and Exchange Commission's rules and regulations. Section 10 (b) prohibits the use of any deceptive device in the "sale" of any security by "any person," and it is irrelevant that Manhattan was a corporation rather than an individual investor; that the fraud was perpetrated by a corporate officer and his outside collaborators; that the transaction was not conducted through a securities exchange or an organized market; that the proceeds due the seller were misappropriated; and that the creditors of the defrauded corporate seller may be the ultimate victims. Pp. 9–14.

430 F. 2d 355, reversed.

DOUGLAS, J., delivered the opinion for a unanimous Court.

Arnold Bauman argued the cause for petitioner. With him on the briefs was *Morton J. Schlossberg.*

William W. Karatz argued the cause and filed a brief for respondent Irving Trust Co. *Irving Parker* argued the cause for respondent Bankers Life & Casualty Co. With him on the brief were *William T. Kirby* and *Isaac M. Bayda. William E. Willis* and *Michael M. Maney* filed a brief for respondents Belgian-American Banking Corp. et al. *William Heller* filed a brief for respondents Garvin, Bantel & Co. et al.

Walter P. North argued the cause for the Securities and Exchange Commission as *amicus curiae* urging reversal. With him on the brief were *Solicitor General Griswold, Peter L. Strauss, Philip A. Loomis, Jr.,* and *Theodore Sonde.*

MR. JUSTICE DOUGLAS delivered the opinion of the Court.

Manhattan Casualty Co., now represented by petitioner, New York's Superintendent of Insurance, was, it is alleged, defrauded in the sale of certain securities in violation of § 17 (a) of the Securities Act of 1933, 48 Stat. 84, 15 U. S. C. § 77q (a), and of § 10 (b) of the Securities Exchange Act of 1934, 48 Stat. 891, 15 U. S. C. § 78j (b). The District Court dismissed the complaint, 300 F. Supp. 1083, and the Court of Appeals affirmed, by a divided bench. 430 F. 2d 355. The case is here on a petition for a writ of certiorari which we granted, 401 U. S. 973.

It seems that Bankers Life & Casualty Co., one of the respondents, agreed to sell all of Manhattan's stock to one Begole for $5,000,000. It is alleged that Begole conspired with one Bourne and others to pay for this stock, not out of their own funds, but with Manhattan's assets. They were alleged to have arranged, through Garvin,

Bantel & Co.—a note brokerage firm—to obtain a $5,000,000 check from respondent Irving Trust Co., although they had no funds on deposit there at the time. On the same day they purchased all the stock of Manhattan from Bankers Life for $5,000,000 and as stockholders and directors, installed one Sweeny as president of Manhattan.

Manhattan then sold its United States Treasury bonds for $4,854,552.67.[1] That amount, plus enough cash to bring the total to $5,000,000, was credited to an account of Manhattan at Irving Trust and the $5,000,000 Irving Trust check was charged against it. As a result, Begole owned all the stock of Manhattan, having used $5,000,000 of Manhattan's assets to purchase it.

To complete the fraudulent scheme, Irving Trust issued a second $5,000,000 check to Manhattan which Sweeny, Manhattan's new president, tendered to Belgian-American Bank & Trust Co. which issued a $5,000,000 certificate of deposit in the name of Manhattan. Sweeny endorsed the certificate of deposit over to New England Note Corp., a company alleged to be controlled by Bourne. Bourne endorsed the certificate over to Belgian-American Banking Corp.[2] as collateral for a $5,000,000 loan from Belgian-American Banking to New England. Its proceeds were paid to Irving Trust to cover the latter's second $5,000,000 check.

Though Manhattan's assets had been depleted, its books reflected only the sale of its Government bonds and the purchase of the certificate of deposit and did

[1] Manhattan's Board of Directors was allegedly deceived into authorizing this sale by the misrepresentation that the proceeds would be exchanged for a certificate of deposit of equal value.

[2] Belgian-American Banking at the same time made a loan to New England Note in the amount of $250,000 which was distributed in part as follows: Belgian-American Banking $100,000, Bourne $50,000, Begole $50,000, and Garvin, Bantel $25,000.

not show that its assets had been used by Begole to pay for his purchase of Manhattan's shares or that the certificate of deposit had been assigned to New England and then pledged to Belgian-American Banking.

Manhattan was the seller of Treasury bonds and, it seems to us, clearly protected by § 10 (b), 15 U. S. C. § 78j (b) of the Securities Exchange Act [3] which makes it unlawful to use "in connection with the purchase or sale" of any security "any manipulative or deceptive device or contrivance" in contravention of the rules and regulations of the Securities and Exchange Commission.[4]

There certainly was an "act" or "practice" within the meaning of Rule 10b–5 [5] which operated as "a fraud or deceit" on Manhattan, the seller of the Government bonds. To be sure, the full market price was paid for those bonds; but the seller was duped into believing that it, the seller, would receive the proceeds. We cannot

[3] Section 10 (b) provides:

"It shall be unlawful for any person . . . [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

[4] Rule 10b–5, 17 CFR § 240.10b–5, provides:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

"(a) To employ any device, scheme, or artifice to defraud,

"(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

"(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

[5] N. 4, *supra*.

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agree with the Court of Appeals that "no investor [was] injured" and that the "purity of the security transaction and the purity of the trading process were unsullied." 430 F. 2d, at 361.

Section 10 (b) outlaws the use "in connection with the purchase or sale" of any security [6] of "any manipulative or deceptive device or contrivance." The Act protects corporations as well as individuals who are sellers of a security. Manhattan was injured as an investor through a deceptive device which deprived it of any compensation for the sale of its valuable block of securities.

The fact that the fraud was perpetrated by an officer of Manhattan and his outside collaborators is irrelevant to our problem. For § 10 (b) bans the use of any deceptive device in the "sale" of any security by "any person." And the fact that the transaction is not conducted through a securities exchange or an organized over-the-counter market is irrelevant to the coverage of § 10 (b). *Hooper* v. *Mountain States Securities Corp.*, 282 F. 2d 195, 201. Likewise irrelevant is the fact that the proceeds of the sale that were due the seller were misappropriated.[7] As the Court of Appeals for the Fifth

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[6] Section 3 (a) (10) of the 1934 Act defines "security" very broadly (see *Tcherepnin* v. *Knight*, 389 U. S. 332) and clearly embraces Treasury bonds.

[7] See, *e. g.*, *Allico Nat. Corp.* v. *Amalgamated Meat Cutters & Butcher Workmen of North America*, 397 F. 2d 727 (CA7 1968), which held sufficient under § 10 (b) and Rule 10b–5 a complaint which charged that defendant union, upon discovering that a third party would pay a higher price, breached a prior agreement to sell 100% of the stock in a wholly owned life insurance company to plaintiffs. The court placed primary reliance on the fact that in the course of the transaction, the union misappropriated some 25,000 shares of the life insurance company's stock which had previously been sold to plaintiffs for cash, but which were being held in escrow pending consummation of the agreement.

"Even if a breach of contract in order to make a more favorable

Circuit said in the *Hooper* case, "Considering the purpose of this legislation, it would be unrealistic to say that a corporation having the capacity to acquire $700,000 worth of assets for its 700,000 shares of stock has suffered no loss if what it gave up was $700,000 but what it got was zero." 282 F. 2d, at 203.

The Congress made clear that "disregard of trust relationships by those whom the law should regard as

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contract would not in itself be sufficient [to confer jurisdiction under § 10 (b)], we have more here. The motivation not only is said to induce a breach of contract . . . but also to induce the conversion of plaintiffs' pledged 25,000 shares." *Id.*, at 729–730. See also *Cooper* v. *North Jersey Trust Co.*, 226 F. Supp. 972 (SDNY 1964), in which a conspiracy to loan plaintiff money to buy securities, followed by the misappropriation of the purchased securities when they were pledged to secure the loan, was held to violate § 10 (b) and Rule 10b–5.

Indeed, misappropriation is a "garden variety" type of fraud compared to the scheme which gave rise to *A. T. Brod & Co.* v. *Perlow*, 375 F. 2d 393 (CA2 1967). That case involved an action by a broker against its own customers for the recovery of losses suffered when defendant customers refused to pay for securities previously ordered which had decreased in value by the settlement date. The complaint charged that this refusal to honor the purchase order was part of the customers' deceptive plan only to pay for securities purchased for their account when those securities had appreciated in value by the date payment was due.

Rejecting the customers' pleas that "no fraud is alleged as to the investment value of the securities nor any fraud 'usually associated with the sale or purchase of securities,'" *id.*, at 396, the Court of Appeals for the Second Circuit—composed of a different panel from the one sitting in the instant case—reversed the District Court's dismissal of the complaint.

"[We do not] think it sound to dismiss a complaint merely because the alleged scheme does not involve the type of fraud that is 'usually associated with the sale or purchase of securities.' We believe that § 10(b) and Rule 10b–5 prohibit *all* fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws." *Id.*, at 397.

fiduciaries, are all a single seamless web" along with manipulation, investor's ignorance, and the like. H. R. Rep. No. 1383, 73d Cong., 2d Sess., 6. Since practices "constantly vary and where practices legitimate for some purposes may be turned to illegitimate and fraudulent means, broad discretionary powers" in the regulatory agency "have been found practically essential." *Id.*, at 7. Hence we do not read § 10 (b) as narrowly as the Court of Appeals; it is not "limited to preserving the integrity of the securities markets" (430 F. 2d, at 361), though that purpose is included. Section 10 (b) must be read flexibly, not technically and restrictively. Since there was a "sale" of a security and since fraud was used "in connection with" it, there is redress under § 10 (b), whatever might be available as a remedy under state law.

We agree that Congress by § 10 (b) did not seek to regulate transactions which constitute no more than internal corporate mismanagement. But we read § 10 (b) to mean that Congress meant to bar deceptive devices and contrivances in the purchase or sale of securities whether conducted in the organized markets or face to face. And the fact that creditors[8] of the defrauded corporate buyer or seller of securities may be the ultimate victims does not warrant disregard of the corporate entity. The controlling stockholder owes the corporation a fiduciary obligation—one "designed for the protection of the entire community of interests in the corporation—creditors as well as stockholders." *Pepper v. Litton*, 308 U. S. 295, 307.

The crux of the present case is that Manhattan suffered an injury as a result of deceptive practices touch-

[8] The history of the Act shows that Congress was especially concerned with the impact of frauds on creditors of corporations. See H. R. Rep. No. 1383, 73d Cong., 2d Sess., 3–4.

ing its sale of securities as an investor. As stated in *Shell* v. *Hensley*, 430 F. 2d 819, 827:

> "When a person who is dealing with a corporation in a securities transaction denies the corporation's directors access to material information known to him, the corporation is disabled from availing itself of an informed judgment on the part of its board regarding the merits of the transaction. In this situation the private right of action recognized under Rule 10b–5 [9] is available as a remedy for the corporate disability."

The case was before the lower courts on a motion to dismiss.

Bankers Life urges that the complaint did not allege, and discovery failed to disclose, any connection between it and the fraud and that, therefore, the dismissal of the complaint as to it was correct and should be affirmed. We make no ruling on this point.

The case must be remanded for trial. We intimate no opinion on the merits, as we have dealt only with allegations and with the question of law whether a cause of action as respects the sale by Manhattan of its Treasury bonds has been charged under § 10 (b).[10] We think it

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[9] It is now established that a private right of action is implied under §10(b). See 6 L. Loss, Securities Regulation 3869–3873 (1969); 3 L. Loss, Securities Regulation 1763 *et seq.* (2d ed. 1961). Cf. *Tcherepnin* v. *Knight*, 389 U. S. 332; *J. I. Case Co.* v. *Borak*, 377 U. S. 426.

[10] Petitioner's complaint bases his single claim for recovery alternatively on three different transactions alleged to confer jurisdiction under § 10 (b): Manhattan's sale of the Treasury bonds; the sale of Manhattan stock by Bankers Life to Bourne and Begole; and the transactions involving the certificates of deposit. We only hold that the alleged fraud is cognizable under § 10 (b) and Rule 10b–5 in the bond sale and we express no opinion as to Manhattan's standing under § 10 (b) and Rule 10b–5 on other phases of the com-

has been so charged and accordingly we reverse and remand for proceedings consistent with this opinion.

All defenses except our ruling on § 10 (b) will be open on remand.

Reversed.

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plaint. See Kellogg, The Inability to Obtain Analytical Precision Where Standing to Sue Under Rule 10b–5 is Involved, 20 Buffalo L. Rev. 93 (1970); Lowenfels, The Demise of the *Birnbaum* Doctrine: A New Era For Rule 10b–5, 54 Va. L. Rev. 268 (1968).